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No.

In the

Supreme Court of the United States

CREFISA INCORPORATED

Petitioner,

versus

WASHINGTON MUTUAL BANK, F.A.
AND HANS LOPEZ-STUBBE, TRUSTEE

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the First Circuit

PETITION FOR A WRIT OF CERTIORARI

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ISSUES PRESENTED FOR REVIEW

1. WHETHER THE DISTRICT COURT PROPERLY REQUESTED THAT THE COMPLETE PURCHASE & ASSUMPTION AGREEMENT BE PRESENTED TO THE COURT, BECAUSE APPELLATE COURTS HAVE THE INHERENT POWER TO SUPPLEMENT THE RECORD ON APPEAL; AND THE COURT COULD ALSO TAKE JUDICIAL NOTICE OF THE FACT THAT THE AGREEMENT WAS INCORPORATED BY REFERENCE IN A BILL OF SALE THAT WAS NOTARIZED.

2. WHETHER THE COURT OF APPEALS VIOLATED THE *ERIE V. TOMPKINS* DOCTRINE, AND OTHER FEDERAL LAW, BY NOT APPLYING A DECISION OF THE SUPREME COURT OF PUERTO RICO AND INSTEAD MADE ITS OWN CONSTRUCTION OF THE LAW, WHICH HAD THE EFFECT OF OVERRULING SUCH DECISION.

PARTIES TO THE PROCEEDINGS

Pursuant to Rule 29.6 of the Rules of this Court, petitioner, Crefisa, Inc. states taht it has no parent, subsidiaries (other than wholly owned).

TABLE OF CONTENTS

PAGE

Questions Presented i

Parties to the Proceedings ii

Table of Contents iii

Table of Authorities v

Opinions Below 1

Jurisdictional Statement 1

Relevant Constitutional Provisions, Treaties, Statutes, Ordinances, and Regulations Involved 1

Statement of the Case 2

Reasons for Granting the Writ 7

II. WHETHER THE COURT OF APPEALS VIOLATED THE *ERIE V. TOMPKINS* DOCTRINE, AND OTHER FEDERAL LAW, BY NOT APPLYING A DECISION OF THE SUPREME COURT OF PUERTO RICO AND INSTEAD MADE ITS OWN CONSTRUCTION OF THE LAW, WHICH HAD THE EFFECT OF OVERRULING SUCH DECISION. 11

Conclusion 24

Appendix

Opinion of the United States Court of Appeals 1a

Decision of the District Court 16a

Decision of the District Court 33a

Decision of the District Court 69a

Excerpt from Appendix 80a

TABLE OF AUTHORITIES

CASES: PAGE

Acosta-Mestre v. Hilton International, 156 F3d 49 (1998) 13

Atherton v. FDIC, 519 US 213 (1997) 21

Boyle v. United Technologies Corp., 487 US 502 (1988) 20

Caguas Co. v. López, 59 PRR 263 (1941) 13, 14, 23

Central W. Rental v. Horizon Leasing, 967 F 2d 832 (1992), ... 22

Clearfield Trust Co. v. United States, 318 US 363 (1943), ... 19

Collazo-Santiago v. Toyota Motors, 149 F3d 23 (1998) 13

Credito & Ahorro Ponceño v. Gorbia, 25 F(2d) 817 14

Dickenson v. Alabama, 667 F 2d 1364 (1982 CA ll): 7

D'Oench, Duhme & Co. v. *FDIC*, 315 US 447 (1942), ... 19

Eric v. Tompkins, 304 US 64 (1938), ... 11, 15, 16, 19, 22

FDIC v. Wood, 758 F 2d 156 (1985), ... 22

FDIC v. Bank of Boulder, 865 F 2d 213 (1988) 22

FDIC v. Clark, 978 F 2d 1541 (1992) 22

FDIC v. Main Hurdman, 655 F. Supp. 259 (1987) 22

FDIC v. Newhart, 892 F 2d 47 (1989). 23

FDIC v. Oehlert, 252 N. W. 2d 728 (1977). 22

Johnson v. Fankell, 520 U.S. 911(1997), ... 12

Landy v. FDIC, 486 F2d 139 (1973 C.A.3). 10

Miree v. De Kalb County, 433 US 25 (1977) 19

National Metropolitan Bank v. United States, 323 US 454 (1945) 19

Notrica v. FDIC, 2 F 3d 961 (1993), ... 22

O'Melveny v. FDIC, 512 US 79 (1994) 21

St. Paul Fire & Marine v. Caguas Fed. Savings, 121 PRR 761 23

United States v. County of Alegheny, 322 US 174 (1944) 19

United States v. Kimbell Foods Inc. 440 US 715 (1979), ... 20

United States v. Standard Oil, 332, US 305 (1947) 19

FEDERAL RULES:

Federal Rule 201(b)(2) of Evidence 9

FRAP10(a)(1), ... 10

STATUTES:

31 PRLA Sec. 3941 ..... 16, 21

31 PRLA sec. 3943 13-15

4 PRLA Sec. 2023 10

4PRLA Sec. 2094 10

Sec. 1418 14

OPINIONS BELOW

The decision of the First Circuit is set forth in the Appendix at 1a and is reported at 186 F. 3d 46. The opinion of the District Court is set forth at 16a and is unreported.

STATEMENT OF THE BASIS OF JURISDICTION OF THE SUPREME COURT

The statutory provision for this Court's jurisdcition is 28 U.S.C. Section 1254. The District Court of Puerto Rico issued its decision on September 11, 1998. An appeal was filed to the First Circuit Court of Appeals. The Court of Appeals reversed the lower court ruling. Panel rehearing and rehearing en banc were timely requested. Rehearing was denied on September 2, 1999. This Petition was timely filed within the 90 days of the denial for rehearing.

CONSTITUTIONAL, STATUTORY AND ORDINANCES PROVISIONS INVOLVED IN THIS CASE.

Art. 1416 of the Puerto Rico Civil Code, 31 PRLA Sec. 3941, which provides:

The assignment of a credit, right, or action shall produce no effect against a third person, but from the time the date is considered fixed, in accordance with sections 3273 and 3282 of this title.

Art. 1418 of the Puerto Rico Civil Code, 31 PRLA Sec. 3943, which provides:

The sale or assignment of a credit includes that of all the accessory rights, such as the security, mortgage, pledge or privilege.

STATEMENT OF THE CASE

In 1986 Milton Rua was the sole stockholder and president of Colonial Mortgage Corporation, which was a mortgage servicing agent for various financial institutions, including the Bowery Savings Bank. In November 1986, Rua opened at Caguas Central Federal Savings a $500,000 savings account and pledged it to a $500,000 loan, both in his name. Payment for the savings account was made by a check from a personal checking account of Rua, to which the loan proceeds were credited. This type of transaction is known as a loophole agreement which is generally employed to obtain a tax deduction for the interest payment. The transaction involves no real transfer of funds, creating only reciprocal obligations between the bank and the depositor.

By mid 87, Bowery discovered that Colonial Mortgage had developed a kiting scheme with Bowery's accounts at other banks and Colonial's accounts at Caguas Central. That scheme resulted in a loss of around $1,000,000 to Bowery. On December 22, 1987, Bowery filed a complaint to recover that loss, at the Federal District Court of Puerto Rico. Colonial, Rua, Caguas Central and other banks were brought as defendants. On December 29, 1987, Colonial filed a bankruptcy petition under Chapter 7, 11 USC 701 et seq, but did not request a stay of the Bowery action and the trustee for Colonial filed a coparty claim against Caguas Central. During the kiting scheme, Rua had used the savings account that he had opened at Caguas Central, to

represent to Colonial's auditors, that the $500,000 were funds held for Bowery. This was done by typing on the back of the passbook the legend: "Colonial Mortgage Bankers, BSB Corp.". The auditors also, purportedly mailed verification request to Caguas Central to confirm that the funds were held by Colonial. Based on that evidence, the Federal District Court held by summary judgement that the $500,000 savings account belonged to Rua and not to Colonial, but Caguas Central had participated with Rua in representing to Bowery that the account held Bowery funds. Therefore, the Court held that Caguas Federal was liable to Bowery in damages in the amount of $500,000, and that Bowery did not have a right to the savings account. On October 31st, 1997, the court dismissed the claim filed by Colonial's trustee against Caguas Central, holding that there was no basis for such claim.

Prior to the October 31st, 1997 judgment, the Bankruptcy Court had issued a turnover order on April 21, 1988, in the Colonial proceeding. The latter order demanded Caguas Central to deliver to the trustee the funds held in the savings account, because he contended that those funds belonged to Colonial. To persuade the court to sustain the order, the Trustee stated that he would hold the funds "segregated from all other accounts, unless and until authorized by the Bankruptcy Code or order of the Court." On November 1, 1988, after Caguas Central unsuccessfully objected on the grounds that the funds belonged to Rua, who did not file a personal bankruptcy proceeding, and that Caguas Federal had a valid pledge on the account, the Court reiterated the turnover order.

On May 24, 1990, RTC was appointed conservator of Caguas Central and on August 1990, was appointed receiver.

On December 21, 1990, RTC sold the assets of Caguas Central to Banco Santander, by a Purchase and Assumption agreement, which included the Rua loan, collateralized with the savings account. The promissory note was indorsed by RTC to Banco Santander, and the later indorsed it to Crefisa, the "Petitioner".

On October 6, 1993, Petitioner filed an adversary proceeding against Colonial's trustee and Bowery to recover the funds. Bowery was included because it had filed in the bankruptcy proceeding an agreement with the trustee that if either one prevailed they would divide the proceeds of the savings account 45% for trustee and 55% for Bowery. The agreement was executed notwithstanding the district court´s judgment that held that neither Bowery nor the trustee was entitled to the funds in the savings account. Thus, their position was to relitigate that issue disregarding the res judicata rule. Petitioner, as an unsecured creditor of Colonial in other loans, had unsuccessfully objected to that agreement on the basis that it amounted to a "preference" to Bowery, who also was an unsecured creditor of Colonial.

The adversary proceeding filed by Petitioner was based in the District Court's judgement that ruled that the funds in the savings account belonged to Rua, that such account was pledged to the loan, and that the D'Oench Duhme v. FDIC doctrine was applicable. Bowery and the trustee denied Crefisa´s allegations and counterclaimed contending that the funds belonged to Bowery or the trustee.

During the discovery proceedings Crefisa did not produce the RTC- Santander purchase agreement, because it was not in Crefisa's possession, but stated that it would be produced later. The trustee and Bowery immediately filed a

motion for summary judgement contending that Crefisa had no standing because it could not show that it had title to the collateral.

Crefisa countered the motion arguing that the indorsement of the loan note by RTC and by Santander was all that Crefisa had to rely on, since under Art. 1418 of the Civil Code a valid transfer of the credit automatically transferred the collateral, and that Crefisa was protected by the D'Oench doctrine and the federal holder in due course doctrine.

The bankruptcy court rejected Crefisa's arguments and dismissed the action, holding that no proof was presented by Crefisa, of the transfer of the collateral.

Crefisa filed a notice of appeal to the District Court and three days later filed a motion to amend judgment in the bankruptcy court, annexing the first nine pages of the RTC-Santander agreement.

The bankruptcy court denied the motion holding that the notice of appeal had deprived the court of jurisdiction.

In the appeal, Crefisa made part of the record on appeal the motion to amend judgement attaching the annexed pages of the RTC-Santander agreement. The trustee and Bowery objected to those documents being included in the record on appeal, because they were not considered by the bankruptcy court in rendering judgement.

The District Court rejected this objection and sua sponte requested that the whole RTC-Santander agreement be filed. The District Court then rendered a judgement reversing

the bankruptcy court, holding that the RTC- Santander agreement did provide for the transfer of the collaterals to the notes, and also, that according to Civil Code the transfer of the note entailed the transfer of the collateral.

On August 2, 1999, the Circuit Court issued judgement in which it properly concluded that "Rua opened a new savings account... with a $500,000 check drawn on his checking account;" that "Rua made a written pledge of the Golden Passbook account as collateral to secure his $500,000 promissory note and any other current or future debts to Caguas"; that "Bowery brought suit in the district cour seeking to recover from Colonial, Caguas, Rua and Rua´s wife about $1,000,000 in diverted Bowery funds"; that thereafter Colonial filed a bankruptcy proceeding, in which "Caguas paid over to the trustee aproximately $557,000 pursuant to the bankruptcy court order, the amount representing the original principal of $500,000 plus accumulated interest"; that in 1990, RTC was appointed receiver for Caguas and indorsed the promissory note to Banco Santander, as part of "a multi-million dollar sale of Caguas´assets by the RTC to Banco Santander pursuant to a purchase and sale agreement"; and that Banco Santander endorsed the note to Crefisa, who brought an adversary proceeding "based on the pledge" requesting the proceeds of the savings account.

Nevertheless, the court reversed the district court´s judgment, holding that the court could not consider the Purchase & Assumption Agreement, because it was not brought to the attention of the bankruptcy court before issuing its judgment.

The circuit court also rejected the second ground adopted by the district court in its judgment, that held the transfer of the promissory note entailed that of the collateral.

As a result, Petitioner filed a petition for rehearing dated August 12, 1999, which was denied by order of the en bank court, dated September 2, 1999.

ARGUMENT

1. THE DISTRICT COURT PROPERLY REQUESTED THAT THE COMPLETE PURCHASE & ASSUMPTION AGREEMENT BE PRESENTED TO THE COURT, BECAUSE APPELLATE COURTS HAVE THE INHERENT POWER TO SUPPLEMENT THE RECORD ON APPEAL; AND THE COURT COULD ALSO TAKE JUDICIAL NOTICE OF THE FACT THAT THE AGREEMENT WAS INCORPORATED BY REFERENCE IN A BILL OF SALE THAT WAS NOTARIZED.

If the Circuit Court of Appeals' decision is not reversed and the Petitioner is not allowed to supplement the record when the parties and the judge knew of the forthcoming evidence, then this Court would be accomodating a potential change in controlling law. The inherent power to supplement the record on appeal has been recognized by various appellate courts, as stated in *Dickenson v. Alabama*, 667 F 2d 1364 (1982 CA ll):

> While federal appellate courts do not often supplement the record on appeal with evidence not reviewed by the court below, it is clear that the authority to do so exists.

See, e.g., Erkins v. Bryan, 663 F2d 1048, 1052 W.1 (11th Cir., 1981); United States v. Oulet, 618 F2d 182, 187 (2d Cir. 1980); Tark v. United States, 429 F2d 1327, 1329 (8th Cir. 1970); Gatewood v. United States, 209 F2d 789, 792-93 (D.C. Cir. 1953). Whether an appellate record should be supplemented under the particular circumstances of a case is a matter left to the discretion of the federal courts of appeal. Cf. Singleton v. Wulff, 428 U.S. 106, 121, 96 S. Ct. 2868, 2877, 49 L. Ed 826 (1976) (issues raised for the first time on appeal). For several reasons, we view it appropriate to include the state court trial transcript in the record of this case. First, we believe that the proper resolution of the substantive issues in this case, viewed in the context of all of the relevant historical facts, is beyond any doubt. Id. Second, a decision to remand this case for the sole purpose of allowing the district court to review several additional significant facts contained in the transcript would be contrary to both the interests of justice and the efficient use of judicial resources. At least one dispositive issue in this appeal raises a pure question of law, and, thus, there is no need for an evidentiary hearing to be held. Finally, it should be remembered that, in effect, we are reviewing the District Court's review of the habeas corpus claim of a state prisioner.

In the instant case, it was also discretionary for the district court, sitting on appeal, to supplement the record on appeal, by requesting that the complete Purchase & Assumption Agreement be filed. The first two reasons stated in the quoted Dickerson case: are also applicable to the instant case; the proper resolution of the substantive issues; the interests of justice; and the efficient use of judicial resources. Furthermore, the district court also considered that the complete P & A Agreement should be filed, to determine whether there was any condition in the agreement that would make the collateral unavailable to Banco Santander. The Court, thus, requested the complete agreement to determine whether there were any conditions that would favor Bowery and the trustee, vis-a-vis Crefisa, and not vise versa. The underlying reason was that if there were no conditions limiting the transfer of the collateral, the transfer took place, as a matter of law.

Absent any abuse of the inherent discretionary power of the district court to supplement the record on appeal, it was a plain error for the court of appeals to deny that power.

Furthermore, the district court, sitting on appeal, could also take judicial notice under Federal Rule 201(b)(2) of Evidence, of the complete P & A Agreement, regardless of the inherent power of the court to supplement the record on appeal.

Under Rule 201(b)(2), an appellate court may take judicial notice of a fact "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned."

A notarized document is capable of accurate and ready determination by resort to the document itself, whose accuracy cannot reasonable be questioned. The notarized document in the instant case is the Quit Claim Bill of Sale, that incorporated the P & A Agreement, by reference.

The Quit Claim Bill of Sale, by being notarized, gave the document a date certain, which is one of the ways allowed by the Civil Code of Puerto Rico, to validate a contract as against third parties, as further discussed below.

The notarization of a document not only can be accurately determined on the face of the document, but also by the recording of such notarization in the book of affidavits that the notary is required by Puerto Rico law, to record such affidavits (4PRLA Sec. 2094); and by the monthly statement of affidavits that the notary is required by the law to file with the Inspector of Notaries (4 PRLA Sec. 2023).

Appellate courts may also take "judicial notice of the developments since the appeal, including filings, motions and orders in the district court." *Landy v. FDIC*, 486 F2d 139 (1973 C.A.3). Since part of the P.A. Agreement was included in the Motion to Amend Judgment, filed in the bankruptcy court, it was proper for the District Court to take judicial knowledge of at least, that part of the agreement, which was also a proper part of the record on appeal under FRAP10(a)(1), that provides that the "original papers and exhibits filed... shall constitute the record on appeal." Rule 10(a)(1) does not limit the record on appeal to documents that were filed prior to the appealed judgment, as the circuit court held in the instant case.

It thus follows , that the district court had the inherent discretionary power to request that the complete P & A Agreement be filed; that the district court could also take judicial knowledge of the P & A Agreement, on account of its notarization; and could also take judicial notice of the part of the agreement that was filed at the bankruptcy court, which was a proper document in the record on appeal, under FRAP 10(a)(1).

Moreover, the complete Purchase & Assumption Agreement was not a surprise to any party or judge. Everyone knew the asset had been obtained from the RTC and there had to be a document evidencing the transfer. This was made clear to Bowery and the trustee when petitioner subsrituted RTC in the Bankruotcy Court, based on the P & A Agreement, before the adversary proceeding was filed. The only party prejudiced by the Circuit Court's decision is the Petitioner,. since the court was notified of the existence of an agreement, but barred Petitioner from using it. The evidence was no surprise so the Circuit Court erred in disregarding the agreement.

2. WHETHER THE COURT OF APPEALS VIOLATED THE *ERIE V. TOMPKINS* DOCTRINE, AND OTHER FEDERAL LAW, BY NOT APPLYING A DECISION OF THE SUPREME COURT OF PUERTO RICO AND INSTEAD MADE ITS OWN CONSTRUCTION OF THE LAW, WHICH HAD THE EFFECT OF OVERRULING SUCH DECISION.

Eric v. Tompkins, 304 US 64 (1938), specifically held that:

> Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern.
>
> ***
>
> "Supervision over either the legislative or the judicial action of the states is in no case permissible except as to matters by the Constitution specially authorized or delegated to the United States. Any interference with either, except as thus permitted, is an invasion of the authority of the state and to that extent, a denial of its independence."

Three years ago, this Court reiterated those principles, in *Johnson v. Fankell,* 520 U.S. 911(1997), holding that:

> Even if the Idaho and federal statutes contained identical language-and they do not- the interpretation of the Idaho satute by the Idaho Supreme Court would be binding on the federal courts. Neither this Court nor any other federal tribunal has the authority to place a construction on a state statute different from the one rendered by the highest court of the state. [Citations omited]
>
> This proposition, fundamental to our system of federalism is applicable to

> procedural as well as substantive rules. [citation omited].

The First Circuit Court of Appeals has followed those principles in cases involving Puerto Rico laws. *Acosta-Mestre v. Hilton International*, 156 F3d 49 (1998); *Collazo-Santiago v. Toyota Motors*, 149 F3d 23 (1998). But in the instant case, the lower court violated the Erie and Johnson cases doctrine when it declined to follow *Caguas Co. v. López*, 59 PRR 263 (1941), because that case applied 31 PRLA sec. 3943 to negotiable instruments "without much discussion." The court then made its own construction of Sec. 3943, as requiring also application of Sec. 3941, with the result that the promissory note was validly transfered, but without the collateral. A reading of *Caguas* makes it clear that the transfer of a negotiable instrument entails that of the collateral, by application of Sec. 3943.

In *Caguas* the defendant raised the defense that the plaintiff was "not entitled to enforce the payment of the promissory note" because it did not appear that the security contract had also been asssigned. The lower court rejected that defense stating that:

> Such defense is enterly without merit. It amounts to claiming that a credit cannot be assigned unless rights subsidiary thereto are expressly transferred. Section 1418 of the Civil Code, 1930 ed. provides that the sale or assignment of a credit includes that of all accessory rights, and in *Credito y Ahorro Ponceño v. Gorbia*, 25 F2d 817, it was held that a promissory note secured by a crop lien could be validly

> assigned without expressly assigning the crop-loan contract.

The Supreme Court of Puerto Rico, after holding that the promissory note was covered by the Negotiable Instruments Law of Puerto Rico, upheld the lower courts' ruling, applying both Section 1418 and the *Credito y Ahorro Ponceño* case, stating as follows:

> As to the contention that the note is not enforcible because the same is subject to the crop-loan contract, the law and authorities are to the contrary. Section 1418 of the Civil Code (1930 ed,) provides that "the sale or assignment of a credit includes that of all the accessory rights, such as the security, mortgage, pledge or privilege."***

In *Credito & Ahorro Ponceño v. Gorbia*, 25 F(2d) 817, in which section 1418, *supra*, was construed, it was held that if the promissory notes of some colonos were secured by the tobacco the object of a crop-loan contract, the possession of said tobacco passed to the bank upon the transfer to it of the notes.

In the *Credito y Ahorro Ponceño v. Gorbia* case, cited in *Caguas Co. v. López*, the First Court of Appeals, also applying Sec. 1418, then sec. 1431, and now 31 PRLA Sec. 3943, had held as follows:

> It must be conceded that, if the colono's notes were secured by the 948 quintals and 39 pound (948.39) of tobacco

> by way of a lien thereon, the right to the possession of the tobacco passed to the bank upon the transfer to it of the notes on April 16, 1921; for under the Code of Porto Rico "The sale or assignment of a credit includes that of all the accessory rights, such as the security, mortgage, pledge, or privilege." Civil Code of Porto Rico, Sec. 1431; Rev . Stats. and Codes of Porto Rico 1911, p. 760; 10 Manresa, pp. 350, 351. This is also the principle of the common law. Hilton v. Woodman's estate, 124 Mich. 326, 82 N.W. 1056; McDonald v. Kelly, 14 R.I. 335; Lyon v. Summers, 7 Conn. 399; Batchelder v. Jenness, 59 Vt. 104, 7 A. 279; Hurt v. Wilson, 38 Cal. 263; Perot v.Levasseur, 21 La.Ann.529.

The Circuit Court's refused to apply *Caguas*, supra, because that case applied Sec. 3943 "without much discussion". The Circuit Court not only violated *Erie and Johnson, supra,* but also failed to recognize that when a statutory construction is clear it will be adopted "without much discussion." Only unclear constructions require extended discussions.

In the instant case, the Court of Appeals declined to follow the *Caguas* case, making its own statutory construction of Sec. 3943, as requiring also application of Sec. 3941, that provides that the assignment of a credit "shall produce no effect against a third person but from the time the date is considered fixed." The date is considered fixed, inter alia, when the document is notarized or filed in a public register.

The Court of Appeals stated that "there is no indication in this record that the note was transferred by a notarized document" nor that "the assignment of the debt was filed in a public registry." The Court then held:

> While the transfer of the note remains valid under the Negotiable Instruments Law... it is hard to see how the transfer of a security interest under section 3943 can be given effect based on an assignment of a debt that is not allowed under Section 3941 to affect a third person unless and until the assignment is registered. If there is an answer to this objection, neither the district court nor Crefisa has supplied it.

Of course no answer could have been given to an objection that was brought up for the first time in the judgment rendered by the Appellate Court. There are various substantial objections to that construction, the first one being that it disregards the *Caguas* decision, in violation of the *Erie and Johnson cases*, as was discussed above.

The second objection is that application of Sec. 3941 to negotiable instruments, validating the transfer of the note, and invalidating the transfer of the collateral disrupts the interrelation of Sec. 3941 with Sec. 3943, and the principle underlying this later section.

Sec. 3943 is one of several applications of the principle of the Civil Code that the accessory follows the principal. Application of Sec. 3941 requires that both the accessory and the principal be transferred, or that neither be

transferred if the transfer is invalid. This interrelationship is disrupted if the credit is transferred, but not the collateral.

Sec. 3941 is aimed at preventing a debtor from disposing of his assets to avoid their attachment. The third persons envisioned by sec. 3941, are the creditors of the assignor, and not the whole universe of third persons that are not a party to the contract. No one would dare to suggest that any stranger to the contract can invalidate it, unless he is a creditor of the assignor. And the assets of the assignor that are the focus of Sec. 3941, are the assignor's "credits, rights or actions", not the collaterals, because the collaterals are not assets of the assignor. A pledged or mortgaged collateral properly belongs to its owner and not to the assignor of a collateralized credit. There is no way available for a creditor of an assignor to attach the collateral separately from the credit, because the collateral is not his property. The creditor would have to attach the credit to avail himself of the collateral for payment of the credit, under the principle stated above, that the collateral follows the principal.

Therefore, it is meaningless to hold that a negotiable note is transferred without the collateral when the note does not have a fixed date, because the effect of such transfer would be that the collateral would cease to be such and the property would be liberated from the lien. This amounts to an unwarranted windfall for the owner of the collateral, with no benefit being derived by the assignor's creditors and a damage caused to the assignee, who is deprived of the collateral.

This issue is of great importance in today's economic and banking situations where one bank buys or assumes the asset of another and relies on the collateral. If the collateral

does not attach them, the value of the assets depreciate. The collateral must attach to the security note.

In the instant case, if the holding of the appellate court prevails, the result would be that the savings account's funds would have to be returned to Rua, certainly an undesirable result.

The third objection to the holding of the Circuit Court is that neither Bowery, nor the trustee are creditors of RTC, and therefore are not the third persons contemplated by Sec. 3941. Bowery remains a creditor of Caguas Central, and under FIRREA, had to resort to the RTC's administrative procedure to obtain a pro-rata share of the funds that RTC may have obtained in the sale of Caguas Central's assets to Banco Santander in the P & A Agreement. The trustee, on the other hand, is not a creditor of Caguas Central, because in the Bowery case the district court dismissed the trustee's action against Caguas Central.

Since Colonial and the trustee are not creditors of RTC as a corporate entity, it follows that Sec. 3941 is not available to any of them to invaliate the P & A Agreement, or the transfer of the promisssory note and its collateral.

The fourth objection to the holding of the Cicuit Court, is besides Erie, perhaps the other significant to this Supreme Court. The Circuit Court applied Sec. 3941 to a P & A Agreement executed by the RTC, invalidating the transfer of a collateral made by its provisions. It is a well settled doctrine of this Supreme Court that federal contracts are governed by federal law, and not by inconsistant state law provisions.

Only 4 years after *Erie, supra*, this court held in *D'Oench, Duhme & Co.* v. *FDIC,* 315 US 447 (1942), that the Erie doctrine was not applicable to the FDIC "a federal corporation [that] brings this suit under and Act of Congress", because the liability of the debtor "on the note involves decision of a federal not a state question".

In *Clearfield Trust Co. v. United States*, 318 US 363 (1943), this court again held, citing D'Oench, supra, that Erie does not apply to the "rights and duties of the United States on commecial paper which it issues [which] are governed by federal rather than local law, "adding that: "The desirability of a uniform rule is plain".

In *United States v. County of Alegheny*, 322 US 174 (1944), citing *D'Oench and Clearfield*, this Court held that: "The validity and constructions of contracts through which the United States is exercising its constitucional functions, their consecuences on the rights and obligations of the parties, the titles or liens which they create or permit all present questions of federal law not controlled by the law of any state. "

In *National Metropolitan Bank v. United* States, 323 US 454 (1945), *Clearfield* was reiterated in that the issuance and circulation of commercial paper by the government is governed by federal are not local law. In *United States v. Standard Oil*, 332, US 305 (1947), *Clearfield and National Metropolitan* were reiterated.

However, in *Miree v. De Kalb County*, 433 US 25 (1977), although a federal agency contract was involved, this Court applied state law, because the federal agency was not a

party in the case, and the issue was plaintiff's standing to sue the defendant. This Court stated:

> The litigation before us raises no question regarding the liability of the United States or the responsibilities of the United States under the contracts. The relevant inquiry is a narrow one: Whether petitioners... have standing to sue respondant. While federal common law may govern even in diversity cases where a uniform national rule is necessary to further the interest of the Federal government... the application of federal common law to resolve the issue presented here would promote no federal interest...."

In *United States v. Kimbell Foods Inc.* 440 US 715 (1979), this Court held that federal law governs SBA and FHA loan priorities but state law is adopted as the appropriate federal rule, since a national rule is unnecesary to protect the federal interest in the loan programs.

In *Boyle v. United Technologies Corp.*, 487 US 502 (1988) this Court held that liability of a government contractor is governed by federal law. In rejecting the argument that there was no law inminizing the contractors, this Court reiterated, inter alia, D'Oench, Clearfield and Kimbell, for the proposition that there are areas "so committed by the Constitution and laws of the United States to federal control that state law is pre-empted and replaced, where necessary".

In *O'Melveny v. FDIC*, 512 US 79 (1994), this Court held that when the FDIC acts as a receiver, it steps in the shoes of the bank and if the FDIC brings an action under state law as receiver, state law defenses apply.

Finally in *Atherton v. FDIC*, 519 US 213 (1997) this Court held that when the FDIC is acting as a receiver "it is not pursuing the interest of the Federal Government" [and thus the Court] "can find no significant conflict with, or threat to, a federal interest".

In the instant case, unlike *O'Melveny and Atherton*, an RTC's P & A agreement is involved. Since a federal agency contract is involved, federal law applies, as held in the *D'Oench, Clearfield, Alegheny, National Metropolitan Bank, Standard Oil and Boyle* cases.

As previously stated, the P & A Agreement was incorporated by reference in a notarized bill of sale. If the district court properly supplemented the record on appeal, or could properly take judicial notice of the agreement, it is clear that the agreement complied with sec. 3941, and it was a plain error for the Circuit Court to hold otherwise.

If the Circuit Court limited its holding to the promissory note, the federal law argument still prevails because the note was transferred under the P & A agreement. The agreement itself provided that federal law governed its provisions and only Puerto Rico law that would not frustrate its provisions would apply.

Since the Circuit Court required that the note be notarized or registered in a public register for a valid transfer of the collateral, it applied inconsistent Puerto Rico law to a

transfer made by RTC in its governmental function and not as a receiver. The effect of that application was to invalidate a transfer made by RTC in a P & A Agreement.

Federal agency contracts should not be invalidated by inconsistent local laws, specially laws that are designed to invalidate the transfer of assets by private parties to avoid their attachment by their creditors. FIRREA does not allow creditors of the defunct bank to attach assets that belonged to the bank. Nor could there be present in RTC the purpose of disposing of the assets infraud of **its creditors.**

The above argument assumes that the Circuit Court did not violate the *Erie* doctrine and properly construed Sec. 3941, as allowing the transfer of the note, but not that of the collateral.

Numerous cases have held that assignments and rights of the FDIC on promissory notes are governed by federal law and not by inconsistent state law. *FDIC v. Martin*, 770 F. Supp 623 (1991), *FDIC v. Main Hurdman*, 655 F. Supp. 259 (1987), *FDIC v. Bank of Boulder*, 858 F 2d 594 (1988), *FDIC v. Bank of Boulder*, 865 F 2d 213 (1988), *FDIC v. Bank of Boulder*, 911 F 2d 213 (1990), *Central W. Rental v. Horizon Leasing*, 967 F 2d 832 (1992), *FDIC v. Clark*, 978 F 2d 1541 (1992), *FDIC v. Wood*, 758 F 2d 156 (1985), *Notrica v. FDIC*, 2 F 3d 961 (1993), *FDIC v. Oehlert*, 252 N. W. 2d 728 (1977). It is evident that sec. 3941 as construed by the Circuit Court is inconsistent with RTC's assignment of promissry notes and their collateral, and should not prevail.

The fifth argument against the Circuit Court's objection is that when the Uniform Negotiable Instrument Law was adopted in Puerto Rico in the year 1936, it was

adopted with the principles that existed in its construction under common law. One of such principles of the common law was and still is that the security follows the note as was recognized in Credito y Ahorro Ponceño v. Gorbia, supra, when the court citing six cases said that: " This is also the principle of the common law". For a statement of that principle and the numerous cases supporting it see: Am. Jur. 2d, Bills and Notes Sec. 379 and 38 Am. Jur. 2d. Guarantee, Sec. 36. Sec. 3-201 of the UCC, which has been adopted by the 50 states and Puerto Rico provides that "the transfer of an instrument vest in the transfer such rights as the transferor has therein". See *FDIC v. Newhart*, 892 F 2d 47 (1989). Such rights naturally include the security to the note.

In *St. Paul Fire & Marine v. Caguas Fed. Savings*, 121 PRR 761, the Supreme Court of Puerto Rico stated, regarding the Negotiable Instruments Law "that when a Puerto Rican law maker adopts a statute from another jurisdiction he also adopts the construction of the same made by the highest court of said jurisdiction as of the date the statute is adopted." Thus when the Negotiable Instrument Law was adopted in Puerto Rico, it came with the common law rule that the security follows the note, as was specifically held in *Caguas, supra*, a case that has been applied in Puerto Rico since its issuance in 1941, to all transfers of secured notes.

Since 1941, no transfer of a secured negotiable note is notarized, nor filed in a public register, a practice that was followed in the P & A Agreement and in the transfer of the notes by Banco Santander to Crefisa, in the instant case. After almost 60 years of that practice, the Circuit Court now makes its own interpretation of the law holding that the collateral is not transferred, a decision that will affect

thousands of past, present and future transactions in Puerto Rico, in which negotiable notes and their collaterals are transferred without notarization of the transfer; particularly after attorneys for the Bowery and the trustee made public their version of the new law that the circuit court had established, in a full page of El Nuevo Día, on August 15, 1999, the main newspaper on the island.

CONCLUSION

The court should grant certiorari to review these important matters and reverse the First Circuit Court of Appeals since the Circuit Court misapplied state and federal law.

Respectfully submitted,

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(Any footnotes trail end of each document)
LEXSEE 186 F.3d 46

IN RE: COLONIAL MORTGAGE BANKERS CORPORATION, Debtor. CREFISA INCORPORATED, Plaintiff, Appellee, v. WASHINGTON MUTUAL BANK, F.A., Defendant, Appellant. HANS LOPEZ-STUBBE, TRUSTEE, Appellant.

No. 98-2273

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

186 F.3d 46; 1999 U.S. App. LEXIS 18046

August 2, 1999, Decided

COUNSEL:
Ivan R. Fernandez-Vallejo with whom Rodriguez & Fernandez, Jorge Souss and Goldman Antonetti & Cordova, P.S.C. were on brief for appellants.

Luis R. Montanez-Aviles with whom Montanez & Alicea Law Offices was on brief for appellee.

JUDGES:
Before Selya, Boudin and Lipez, Circuit Judges.

OPINIONBY:
BOUDIN

OPINION:

BOUDIN, Circuit Judge. This appeal is taken from a decision of the United States District Court for the District of Puerto Rico reversing a decision of the federal bankruptcy court. In substance, the district court sustained a claim by Crefisa, Inc., requiring the bankruptcy trustee of Colonial Mortgage Bankers Corporation ("Colonial") to pay over approximately $ 557,000 comprising security for a note held by Crefisa. The background events are somewhat complicated.

In the 1980s, Colonial was engaged in the business of servicing mortgages. One of its clients was the Bowery Savings Bank ("Bowery") (Washington Mutual Bank has now been substituted for Bowery but it simplifies matters to refer only to Bowery). By agreement, Colonial collected mortgage payments due to Bowery and deposited them into Colonial accounts--in trust for Bowery--in two different Puerto Rico banks: Financiero and Banco Santander. The president of Colonial was Milton J. Rua.

In 1980, Rua began a set of transactions that led to the present case by requesting a $ 500,000 loan from Caguas Central Federal Savings Bank ("Caguas"), a bank with which Colonial, Rua, or both had had past dealings. The loan to Rua, which may have been irregular, involved Rua's execution on November 26, 1986, of a promissory note due on demand for $ 500,000 in favor of Caguas. On November 28, 1986, the loan was completed through the following transactions:

> Caguas made a $ 500,000 deposit representing the loan into Rua's personal checking account in the bank;

> Rua opened a new savings account at the bank called a Golden Passbook account with a $ 500,000 check drawn on his checking account;
>
> Rua made a written pledge of the Golden Passbook account as collateral to secure his $ 500,000 promissory note and any other current or future debts to Caguas.

The Golden Passbook account--the treasure trove in this case--was opened as a personal savings account of Rua, but the passbook bore the legend "Colonial Mortgage Bank, B.S.B., Corp." (the "B.S.B." apparently standing for Bowery Savings Bank) and the passbook was later shown to Bowery auditors to persuade them that the account held funds in Colonial's name belonging to Bowery. There is some indication that Rua later sought to transfer ownership of the Golden Passbook account to Colonial but that Caguas rejected this effort on the ground that it did not maintain savings accounts for corporations.

In December 1987, Colonial filed for bankruptcy giving rise to the present case. Puerto Rico financial authorities later concluded that Colonial and Rua had diverted millions of dollars from trust accounts that Colonial had managed and had channeled the money into accounts at the Caguas bank where the funds were expended for the benefit of Colonial and Rua. In all events, in the same month as the Colonial bankruptcy, Bowery brought suit in the district court seeking to recover from Colonial, Caguas, Rua and Rua's wife about

$ 1,000,000 in diverted Bowery funds. Bowery Savings Bank v. Colonial Mortgage Bankers Corp., 87-874-RLA (D.P.R.) In April 1988, the bankruptcy court entered an order at the behest of Colonial's bankruptcy trustee, Hans Lopez-Stubbe, requiring Caguas to turn over the funds in the Golden Passbook account to the trustee.[1] The trustee's theory, it appears, was that the funds, being held in the Golden Passbook account with a passbook bearing Colonial's name, properly belonged to Colonial's estate. In November 1989, Caguas paid over to the trustee approximately $ 557,000 pursuant to the bankruptcy court order, the amount representing the original principal of $ 500,000 plus accumulated interest.

In 1990, Caguas failed, and the Resolution Trust Corporation ("RTC") was appointed, initially as conservator for Caguas and later as its receiver. Thereafter, the RTC on December 21, 1990, endorsed Rua's promissory note in favor of Caguas to Banco Santander. The note was later re-endorsed by Banco Santander to Crefisa, which is apparently a wholly owned subsidiary of Banco Santander. The endorsement was part of a multi-million dollar sale of Caguas' assets by the RTC to Banco Santander pursuant to a purchase and sale agreement. But the question whether the terms of the purchase and sale agreement are properly considered in this case is one of the contested issues on this appeal.

On October 6, 1991, Crefisa brought an adversary proceeding in the Colonial bankruptcy case asserting a security interest in the Golden Passbook account; the claim was based on the pledge of the Golden Passbook account that Rua had made to Caguas on November 28, 1986, to secure his promissory note. Since the funds in the Golden Passbook account had

been turned over to the trustee pursuant to the bankruptcy court's earlier order, the relief sought by Crefisa was an order from the bankruptcy court requiring the trustee to transfer the proceeds to Crefisa.

The bankruptcy trustee, supported by Bowery, opposed Crefisa's request that the funds derived from the Golden Passbook account be transferred to Crefisa and filed a discovery request to identify the basis for Crefisa's claim to a security interest in the account. In April 1994, Crefisa produced Rua's promissory note to Caguas, whose markings showed that it had been endorsed successively by the RTC to Banco Santander and by Banco Santander to Crefisa. The trustee then moved to dismiss Crefisa's adversary proceeding or for summary judgment; he asserted that Crefisa had not established any interest in the Golden Passbook account since the promissory note made no reference to any security and Crefisa had provided no other evidence to support its claim to the security.

After additional filings but no further pertinent evidence from Crefisa, the bankruptcy court on January 25, 1995, issued a decision in favor of the trustee and dismissed Crefisa's complaint. In a nutshell, the bankruptcy court ruled that the promissory note's transfer was governed by Puerto Rico's Negotiable Instruments Law,[2] which did not provide for automatic transfer of the security for an assigned note, rather than by the Civil Code, P.R. Laws Ann. tit. 31, § 1 et seq.; and even if the Civil Code were applicable to the transfer, its requirements for an automatic transfer of a security interest had not been met as to third parties, see P.R. Laws Ann. tit. 31, § 3941. Since the promissory note made no mention of security, Crefisa had not shown that it had obtained Caguas'

security interest in the account. The bankruptcy court entered judgment against Crefisa, and Crefisa appealed to the district court on March 3, 1995.

Three days later, on March 6, 1995, Crefisa filed a motion in the bankruptcy court to amend the judgment, tendering portions of the purchase and sale agreement dated December 21, 1990, between the RTC and Banco Santander for the sale of the Caguas assets to Banco Santander. The bankruptcy judge later denied the motion on the ground that it lacked jurisdiction because of the then-pending Crefisa appeal to the district court. The trustee also moved in the district court to strike the agreement from the record on appeal, but in various orders in the spring of 1996, the district court denied the motion to strike and asked Crefisa to submit a complete copy of the purchase and sale document. Crefisa filings in June 1996 and November 1996 purported to comply with this request and to add further information about the RTC-Banco Santander transaction.

In July 1996, the trustee and Bowery moved to "dismiss the appeal" to the district court, essentially arguing the merits of the appeal and defending the bankruptcy court's decision. On August 27, 1996, Crefisa opposed the motion but also argued the merits, urging that the bankruptcy judge had erred. On September 14, 1998, the district court released a decision and judgment reversing the bankruptcy court and determining that Crefisa was entitled to claim a security interest in the Golden Passbook account.

In its decision, the district court found that the purchase and sale agreement between RTC and Banco Santander confirmed the intent of the parties to effect a transfer of the

security interest. Alternatively, the court ruled that Caguas' security interest in the Golden Passbook account had been transferred by operation of law under the Civil Code by virtue of transfer of Rua's promissory note from Caguas, through the RTC and Banco Santander, to Crefisa; in the court's view the Negotiable Instruments Law governed the transfer of the note and the Civil Code provided for an automatic transfer of the security interest.

The trustee and Bowery now appeal, asking that we reinstate the bankruptcy court's ruling and confirm the trustee's right to the Golden Passbook account proceeds. Their first argument is that as a procedural matter, the district court had no business considering the purchase and sale agreement because it had not been offered in evidence in the bankruptcy court; and their second argument is that the district court's alternative reliance on the Civil Code to effect an automatic transfer of the security misreads the substantive law. (A third argument merely repeats fragments of the first two.)

On the procedural issue, we sympathize with the district court's desire to know the full story of the transfer but agree with the trustee that the district court was not entitled to consider the purchase and sale agreement. In an appeal from the bankruptcy court, the district court sits in an appellate capacity, Fed. R. Bankr. P. 8001; and, just as a circuit court is limited to the district court record, 16A Wright, Miller & Cooper, Federal Practice and Procedure § 3956.2, at 337 (3d ed. 1999), so the district court is normally limited to the evidentiary record compiled in the bankruptcy court, *Crawford v. Lamantia, 34 F.3d 28, 31* (1st Cir.), cert. denied, *514 U.S. 1032, 131 L. Ed. 2d 244, 115 S. Ct. 1393 (1995); In re Armorflite Precision, Inc., 48 B.R. 994, 997 (D. Me. 1985).*

In rejecting the trustee's motion to strike, the district court said in substance that the purchase and sale agreement was material to the dispute. This is at least arguably so. But when a party that has favorable evidence fails to proffer it before the trial court decides a matter, the fact that the evidence would have been material if offered does not mean that it can be considered on the appeal. The reason is obvious: the procedures used on appellate review are not designed to vet new evidence or allow an effective evidentiary response to it.

When the bankruptcy judge decided the trustee's motion to dismiss or for summary judgment, the purchase and sale agreement was not considered because Crefisa failed to submit it in opposition to the trustee's motion. On review, the question for the district court was whether the bankruptcy judge reached the right decision on the record made by the parties. Crefisa is mistaken in arguing that the district court was entitled to consider the purchase and sale agreement as evidence of the transfer of the security interest simply because the agreement was physically annexed to Crefisa's later motion to amend the judgment. See *Kirshner v. Uniden Corp., 842 F.2d 1074, 1077 (9th Cir. 1988).*

Of course, Crefisa could have sought review in the district court of the bankruptcy judge's post-decision refusal to enlarge the record. For that purpose, the agreement would be available to the district court, like an offer of proof, for the purpose of determining whether that refusal was error (but only for that purpose). However, Crefisa makes no claim in this court that the bankruptcy judge erred in denying the post-decision motion to amend the judgment and there is no

indication that that denial was even appealed to the district court.

Limiting the evidence to that properly before the trier of fact is not some ritual or formality. If Crefisa had offered the agreement in the bankruptcy court in timely fashion, the trustee would have been entitled to dispute the validity or significance of the agreement or offer counter-evidence of his own. The trustee lists for us some of his objections to the agreement, saying inter alia that the document was incomplete, lacked a signature page, is only an agreement for a future transaction, and--being between RTC and Banco Santander--does not transfer anything to Crefisa. But a party objecting to evidence newly tendered on appeal is not obliged to show unfair prejudice: the point is that new evidence, which could have been offered in the trial court, is not supposed to be proffered for the first time in an appellate setting.

There are qualifications to every general rule. See 16A Wright, Miller & Cooper, supra, § 3956.4, at 349-50. Occasions exist on which appellate panels do need to consider facts not before the trial court (e.g., on claims of mootness), and procedures exist for reopening judgments to consider newly discovered evidence. Fed. R. Civ. P. 60(b)(2). But Crefisa has pointed us to no exception or extraordinary circumstance that might embrace the purchase and sale document submitted in this case--a document that ought to have been known to Crefisa from the outset and whose completeness and significance are open to substantial questions.

This brings us to the trustee's attack on the district court's alternative ground for its decision, namely, the court's ruling that even apart from the agreement, the admitted endorsement of the note by the RTC to Banco Santander and then by it to Crefisa carried the security interest with it by operation of law. It is common ground that the Negotiable Instruments Law, which provides for the transfer of the note merely by endorsement, says nothing about the transfer of security interests. The bankruptcy judge took the view that Crefisa could not "pick and choose," using the Negotiable Instruments Law to effect the assignment of the note and the Civil Code to transfer the security.

But we read the Negotiable Instruments Law as inviting supplementation wherever it is itself silent: "In any case not provided for in this title [the Negotiable Instruments Law] the rules of the Law Merchant, Civil Law and Equity shall govern." P.R. Laws Ann. tit. 19, § 386; see also P.R. Laws Ann. tit. 31, § 12. Only if there is a conflict with respect to a negotiable instrument does "this title" automatically prevail. E.g., *Paris v. Canety, 73 P.R.R. 386, 388 (1952).* And nothing in the Negotiable Instruments Law forbids a transfer of a security interest incident to the endorsement of a note.

The next question, then, is whether Puerto Rico law does provide that the assignment of a debt transfers a security interest in property pledged to secure the debt. Crefisa relies directly on the Civil Code provision, codified at P.R. Laws Ann. tit. 31, § 3943, which says that "the sale or assignment of a credit [i.e., the right to collect a debt] includes that of all the accessory rights, such as the security, mortgage, pledge, or privilege." The district judge took section 3943 as

providing an alternative ground for upholding Crefisa's right to the security interest at issue in this case.

It appears to be true that section 3943, in providing for automatic transfer of security interests, has been treated without much discussion as applying to negotiable notes. *Credito Y Ahorro Ponceno v. Gorbia, 25 F.2d 817 (1st Cir. 1928); Caguas Co., Inc. v. Lopez, 59 P.R.R. 263, 271 (1941).* However, the same subdivision of the Civil Code containing section 3943 also contains a companion provision, which reads: "The assignment of a credit, right, or action shall produce no effect against a third person but from the time the date is considered fixed, in accordance with sections 3273 and 3282 of this title." P.R. Laws Ann. tit. 31, § 3941.

Sections 3273 and 3282 are primarily evidence provisions somewhat awkwardly adopted by section 3941 for substantive purposes. One deals with proof of public instruments and the other with proof of private instruments. Public instruments are primarily those that have been notarized, P.R. Laws Ann. tit. 31, § 3271, and there is no indication in this record that the note was transferred by a notarized document. Accordingly, the endorsed note in this case appears to qualify (at best) as a private instrument, as to which section 3282 provides in pertinent part:

> The date of a private instrument shall be considered, with regard to third persons, only from the date on which it may have been filed or entered in a public registry, from the death of any of those who signed it, or from the date on which it may have

> been delivered to a public official by virtue of his office.

Thus, coupling sections 3941 and 3282 together, the language of the two provisions indicates that the transfer of "the credit" embodied in the promissory note could have "no effect" under the Civil Code against a third party until some document evidencing the assignment of the debt was filed in a public registry or delivered to a public official. So far as the record shows, this has never occurred. And if the assignment of the debt is not effective against a third party so far as the Civil Code is concerned, it is hard to see how an automatic transfer of a security interest incident to the transfer of the debt can be effective under the Civil Code against a third party.

The district court recognized the objection based on sections 3273, 3282, and 3941 but said that these sections dealt with the effect of the assignments of credits "against a third party," and had no "applicability" in this case. But the trustee is formally a third party vis vis the assignment of the note and/or security interest, and section 3941 is manifestly a limitation on section 3943.[3] While the transfer of the note remains valid under the Negotiable Instruments Law regardless of section 3282, it is hard to see how the transfer of a security interest under section 3943 can be given effect based on an assignment of a debt that is not allowed under section 3941 to affect a third person unless and until the assignment is registered. If there is an answer to this objection, neither the district court nor Crefisa has supplied it.

There is a possible answer. It is fairly easy to guess why section 3941 was framed: without notice of a transfer, a third

party could easily be prejudiced by the private transfer of a debt or by the automatic transfer of an ancillary security interest designed to secure a debt. Seemingly, section 3941 is designed to secure such notice, at least constructively, by a requirement of public filing of the assignment. Of course, a negotiable instrument is designed to be transferred without notice to third parties; but the transfer of a security interest, not mentioned in the note, presents the same danger as the transfer of any property other than a negotiable instrument.

One might reasonably argue that even if the language of section 3941 supports the trustee, its rationale does not apply to him in this instance. After all, the trustee did not take any action (except for litigation expenses) in reliance on Caguas' "ownership" of the security interest. This is far from a case in which the trustee purchased an object from a prior owner only to be faced with a claim that the owner had previously made a secret assignment or sale to another. Thus, one could argue that the trustee should not be able to invoke section 3941 even though literally read it appears to shield him from the effect of section 3943.

This policy argument has not been made by Crefisa and it may or may not be valid. Sometimes statutes are read in accordance with their rationale even in the teeth of statutory language, but other times they do enact rules not perfectly fitted to their rationale. See *Level 3 Communications, Inc. v. Federal Ins. Co., 168 F.3d 956, 958 (7th Cir. 1999)* (Posner, C.J.). Puerto Rico precedent in this case is at best obscure. Cf. *Hernandez v. Iglesias, 58 P.R.R. 406 (1941).* And needless to say, we have not had the benefit of any research by the parties on this issue. Crefisa has forfeited the policy

argument by failing to make it. *Executive Leasing Corp v. Banco Popular, 48 F.3d 66, 67-68 & n.3 (1st Cir. 1995).*

About the best we can say in this instance is that we find the policy argument plausible but not compelling. In these circumstances, we are not going to rescue the district court's judgment on a ground that was not argued to us and may or may not be correct. We have mentioned this possible escape hatch only to be sure that our opinion is not taken to foreclose such an argument if made by the parties in a similar case in the future. Since the problem arises primarily from language in the Civil Code, the replacement of the Negotiable Instrument Law is no assurance against a recurrence of this issue.

For the reasons stated, we conclude that on the record before it the bankruptcy court correctly dismissed Crefisa's adversary petition and that the district court erred in reversing the bankruptcy court. Accordingly, the judgment of the district court is reversed.

----------Footnotes----------

n1 It is not clear whether the order required the payment of the funds to the trustee outright or whether, as other documents suggest, the funds were to be held in custodia legis pending resolution of the claims made by the trustee, Caguas and Bowery.

n2 The Negotiable Instruments Law, P.R. Laws Ann. tit. 19, § 1 et seq., was later repealed, see P.R. Laws Ann. tit. 19, § 401 et seq., but the parties agree that its provisions are still in force as to this transaction.

n3 This is apparent if one juxtaposes the two sections since they then say in substance that the assignment of a debt "includes . . . the security" but the assignment "shall produce no effect against a third person" except from the time that the debt is fixed under section 3273 or section 3282.

LEXSEE 1998 U.S. Dist. LEXIS 14573

IN RE: COLONIAL MORTGAGE BANKERS CORP., Plaintiff-Appellant vs. HANS LOPEZ-STUBBE, TRUSTEE THE BOWERY SAVINGS BANK, Defendants-Appellees

CIVIL 95-1614CCC

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF PUERTO RICO

1998 U.S. Dist. LEXIS 14573

September 11, 1998, Decided

September 14, 1998, Filed

COUNSEL:
For Plaintiff: Luis R. Montanez-Aviles, Esq.

For Defendants: Jorge Souss, Esq., Ivan R. Fernandez-Vallejo, Esq.

JUDGES:
HON. CARMEN CONSUELO CEREZO, Chief, U.S. District Judge.

OPINIONBY:
CARMEN CONSUELO CEREZO

OPINION:

ORDER

This appeal stems from an adversary proceeding filed by CREFISA, Inc., the real estate division of Santander Bank, to recover the sum of $ 500,000 deposited in a savings account (the Golden Passbook Account) which were turned over to the Trustee of Colonial Mortgage Bankers Corp. (Colonial), Hans Lopez Stubbe, in a bankruptcy proceeding filed by the latter. CREFISA, Inc. claims that it is a holder in due course of a $ 500,000 note payable to the order of Caguas Central Federal Savings Bank (Caguas) which was collateralized by the funds deposited in said savings account at the defunct Caguas. CREFISA, Inc. became the holder of this note upon the execution of an Asset Purchase and Sale Agreement on December 21, 1990 between Santander Bank and Resolution Trust Co. (RTC), acting in its capacity as receiver of Caguas. The Bankruptcy Court dismissed the adversary proceeding filed by CREFISA upon a Motion to Dismiss and/or for Summary Judgment based on lack of standing filed by appellees Bowery Savings Bank and the Trustee for Colonial.

In order to simplify the analysis of the factual and legal issues, it is important to narrate the details of the transactions and to define the parties involved in those transactions which are relevant to this case. On November 26, 1986, Milton Juan Rua executed a $ 500,000 note to the order of Caguas, payable upon demand, which evidenced a loan obligation. (Exhibit 1, Appellant's Brief.) The loan funds were disbursed on November 28, 1986, loan # 3838, and deposited in Mr. Rua's account 12-3-00738-8 at Caguas (Exhibit 6, Appellant's brief). On that same date, Mr. Rua issued a check for $ 500,000 payable to Caguas Central Federal Savings Bank from the personal account just mentioned. That check was

used to open the savings account of $ 500,000 which is the object of this appeal and which was identified as the Golden Passbook Savings Account # 12-2-1330 (Exhibit 2, 4 of Appellant's brief). The application to open this savings account, filled out by Mr. Rua, sets forth his name, postal address, social security number and driver's license (Exhibit 3 of Appellant's brief). The passbook itself, however, did not contain his name, but was made out to Colonial Mortgage Bank, B.S.B., Corp.

On November 28, 1986, Milton Juan Rua executed a pledge agreement, affidavit # 36852, pursuant to which he pledged the passbook account 12-2-1330 as collateral "guaranteeing the payment of the current debt and/or any other future debt or obligation of the subscriber Milton Juan Rua." (Exhibit 5 of Appellant's brief.) This pledge agreement was signed by an official of Caguas, as creditor, and Milton Juan Rua, as debtor. The pledge agreement identifies the collateral as "savings account 12-2-1330 in the name of Milton Juan Rua, Esq." See also Exhibit 7 of appellant's brief, where the $ 500,000 loan to Milton Juan Rua, collateralized by a savings account, is listed by the commercial loans department of Caguas as one of the loans approved within the loan officer's authority during the thirty-day period ending December 12, 1986.

It is undisputed that this $ 500,000 loan was never paid by Mr. Rua. When Caguas closed its doors in the year 1990, RTC served as conservator. On December 21, 1990, as mentioned earlier, RTC, acting in its capacity as receiver of the failed banking institution, entered into the Asset Purchase and Sale Agreement with Santander Bank. As owner of all of the assets of Caguas Central, it sold the same to Santander

Bank pursuant to the terms and conditions of said Agreement. This Agreement has been referred to by the parties as Item 11 in the designation of the record on appeal. The total purchase price of all the assets sold by RTC to Santander Bank was $ 682 million. A schedule of the assets sold are attached to the Agreement as Exhibit A, and submitted in compliance with our Order (docket entry 18). Loan 3838, the Rua loan of November 26, 1986, is listed in the schedule of assets sold by RTC to Santander Bank.

Clause 6.7 of the Purchase and Sale Agreement provides that "this Agreement, including any attachment, exhibits and schedules referred to herein and attached contains the entire agreement between the parties." Article 1 of the Agreement sets forth the definitions of certain terms. Clause 1.8 of Article 1 provides that "'collateral' means any real or personal property securing a note," and "note," pursuant to clause 1.15, means "the original executed promissory note evidencing the indebtedness of an obligor under a loan."

Clause 2.6(a), on the matter of Assignments and Endorsements, establishes that for payment of the balance of the purchased price RTC shall deliver to the bank a bill of sale, and additionally,

> shall execute and deliver such individual assignments of security agreements, mortgages, judgments, financing statements, deeds of trust and similar documents as shall be necessary or appropriate to vest in the Bank the full legal right, title and interest in the Assets purchased by the Bank within thirty (30) Business Days after the Closing

> Date. The RTC shall be responsible for the preparation of, and payment of any costs associated with the preparation of, such assignments and other documents. The Bank shall be responsible for the recording of such assignments or other documents and for payment of any costs and recording fees associated with the recording thereof.
>
> (b) Should any additional assignments or other documents be required by applicable law after the thirty-day period following the Closing Date, the Bank shall prepare and submit such additional assignments or documents to the RTC for execution.

Clause 2.6(c) of the Agreement establishes the manner in which RTC would endorse each note, evidencing an asset purchased by Santander Bank. The form of endorsement is described in the following manner: "Pay to the order of Banco Santander Puerto Rico, WITHOUT RECOURSE. RESOLUTION TRUST CORPORATION, as Receiver for Caguas Central Federal Savings Bank." It is undisputed that the $ 500,000 note evidencing Mr. Rua's debt with Caguas was endorsed in this manner.

Article 3, Clause 3.1, of the Agreement, addresses the disclaimer of warranties and representations by RTC. It provides that the assets are sold without recourse and that RTC has made

> no warranties or representations regarding (i) the collectibility of any asset, (ii) the credit worthiness of any obligor (iii) the

> value of any collateral securing payment of any asset, (iv) any asset's documentation or freedom from liens and encumbrances, in whole or in part, or (v) the transferability or enforceability of the notes and collateral documents supporting any asset have been made.

Article 4 sets forth the representations and warranties of the Bank to RTC. At clause 4.2(c), the Bank agrees to "notify all companies providing ... any ... type of insurance for the protection of the assets or the collateral, as required under banking policies."

Clause 4.2(d) of that Article requires Santander Bank to include the following language in any documents reflecting the settlement, restructuring or compromise of any debt or obligation sold by RTC as receiver of Caguas to Santander Bank:

> The parties recognize and acknowledge that the restructuring, modification, settlement or compromise relating to the indebtedness of does not in any way constitute a waiver of any claim, cause of action or right of the RTC against said parties, whether asserted or unasserted, which currently exist, or may arise in the future, pertaining to matters entered into by Caguas Central Federal Savings Bank or any of its subsidiaries, and any of **the parties to the indebtedness or parties to the related guarantees**.

For purposes of our analysis, the most significant clause of the Agreement is 4.2(j) which reads as follows: "The bank further agrees to acknowledge and reaffirm all agreements affecting the collateral, including without limitations leases, security agreements, development agreements and restrictive agreements."

The decisive issue on appeal is whether, when RTC sold the assets of the defunct Caguas Bank to Santander Bank and endorsed and delivered to the Bank the notes evidencing the loans sold, it also transferred the collaterals related to these loans. Although this appeal deals only with the $ 500,000 note payable to Caguas executed on November 26, 1986 by Milton Juan Rua and with the Passbook Account containing the funds deposited by Rua in an equal amount which was pledged as collateral to his loan with Caguas, the issues on appeal require that we consider not only the note and the separate pledge agreement executed by Rua but also the contractual context in which each or both were later transferred to Santander Bank/CREFISA by virtue of the sale by RTC of all of Caguas' assets. A determination of what was the intention of these two contracting parties on the matter of the collaterals is essential to this appeal. The intention of the parties regarding the transfer of the collaterals securing the notes cannot be understood without proper regard of what they specifically agreed to when RTC sold and the Bank purchased the Rua loan, as well as all the other loans of the now defunct Caguas listed in the schedule of assets.

Before addressing the order which has been appealed by CREFISA, it is convenient for purposes of clarity to review the Opinion and Order filed on November 5, 1991 and the Order on reconsideration dated December 5, 1991 issued in Civil 87-1874, an adversary action filed by the Bowery

Savings Bank against Colonial Mortgage Bankers Corp. (Colonial), Mr. Milton Juan Rua, the president of Colonial, Banco Financiero and Caguas Central (Exhibits 8 and 9 of Appellant's brief). That case had to do with a claim by Bowery, one of the appellees before us, against Colonial and Rua for breach of fiduciary duties and for conversion of assets collected by Colonial as Bowery's mortgage servicer. Bowery also claimed that the two defendant banks had acted negligently thereby facilitating Colonial/Rua's fraudulent schemes.

Although the specific transactions by Colonial and Rua that resulted in the diversion of over one million dollars of funds held in trust for Bowery are not relevant to this case, it is important to note that the Court concluded in Civil 87-1874 that the Golden Passbook Savings Account 12-2-1330 was a personal account of Rua, that Rua used a check from his own personal account 12-3-00738-8 to make the $ 500,000 deposit of November 28, 1986 in said savings account, and that he thereafter pledged them as security against the $ 500,000 loan he had obtained from Caguas. See pages 5-8 of the November 5, 1991 Opinion and Order. The Court also determined in that case that, although the Golden Passbook Savings account at Caguas was Rua's personal account, it had on its cover the name of Colonial Mortgage Bank, B.S.B. Corp. and Caguas represented to Bowery auditors that this account was a Colonial account. These findings are repeated at page 3 of the Order denying a motion for reconsideration where the Court ruled that: "we find Caguas liable based on their participation with Rua in the November 1986 transaction and their subsequent act interpreting Rua's assets as those of Colonial." The Court specifically stated at page 3, lines 8-12 that "the Golden Passbook Account, while labeled a Colonial account,

was in fact a personal account of Rua and on two different occasions, Caguas misrepresented this personal account as being a Bowery trust account to Bowery auditors."

Based on these misrepresentations by Caguas and its assistance of Rua/Colonial in their misuse of Bowery's funds, Caguas was held liable to Bowery in the sum of $ 500,000. Before Bowery filed that lawsuit, Colonial had already filed a Chapter 11 proceeding in Bankruptcy Court. Since CREFISA (Santander) had bought, in December 1990, the $ 500,000 note evidencing the Rua loan, along with the other Caguas' assets from RTC, it filed an adversary proceeding to recover the funds pledged by Rua as collateral to the Caguas loan and deposited by him in the Golden Passbook Account which had been turned over to Colonial's Trustee in the bankruptcy proceeding. The Bowery Bank and the Trustee for Colonial filed a motion for summary judgment contending that CREFISA, Inc. lacked standing to claim those funds. The Bankruptcy Court entered summary judgment on February 22, 1995, which was preceded by an Opinion and Order filed on January 25, 1995, concluding that there was "no legal basis ... under the facts ... which support the contention that the $ 500,000 Golden Passbook Account was assigned to the plaintiff CREFISA, Inc., along with the assignment of the promissory note." Opinion and Order at page 10.

Before discussing the core issues, we must address certain errors raised by appellant which have to do with the facts. Appellant CREFISA raises at page 16 of its brief that the Bankruptcy Court incorrectly stated at page 1 of its Opinion and Order that, "at issue is the **ownership** of a $ 500,000 Golden Passbook Account, drawn from a check issued from a personal bank account, and deposited with the now defunct

Caguas Federal Savings Bank (Caguas) by Mr. Milton Rua, president of Colonial on November 28, 1996." (Emphasis ours.) We agree. The District Court's findings in Civil 87-1874 and the bank documents that track the origin of the Golden Passbook savings account funds, which are a part of the record, establish that this was a personal account of Rua. Aside from the fact that the Rua ownership is clearly demonstrated by the bank records, since Bowery, Colonial and Rua were all parties to the litigation in Civil 87-1874 where this determination was made, the issue of ownership of the passbook account cannot be relitigated in the bankruptcy proceeding.

Appellant also points out as incorrect the Bankruptcy Court's statement at page 2 of its opinion that "while the promissory note as well as the check were issued in Mr. Rua's name, the facts indicate that the funds were used to pay Mr. Rua's debts as well as those of Colonial." This is also an erroneous conclusion. It not only directly contradicts the Bankruptcy Court's own footnote number 1 but is unsupported by page 9 of the Opinion and Order issued by the Court in Civil 87-1874, as claimed by the Bankruptcy Court in its footnote 2. The $ 500,000 deposited in the Golden Passbook Savings Account # 12-2-1330 were not spent and remain untouched. The Bankruptcy Court acknowledged this in footnote 1 of its opinion where it states that the passbook account was subject of a bankruptcy order granting the Trustee's request to turn over the sum of $ 506,912.57 deposited in the Caguas Passbook Account, and that, in compliance with that Order, Caguas issued in November 1989 a check in favor of the Trustee for the sum of $ 557,720.86.

As determined by the Court in Civil 87-1874 and as reflected by the documents related to the opening of the passbook account, the $ 500,000 deposited there consisted of the loan funds disbursed by Caguas to Rua in November 1986. The monies diverted by Colonial or Rua from the Bowery Trust account were not placed in the passbook account, although Caguas misrepresented to Bowery auditors that this account was a Colonial/Bowery trust account, instead of a Rua personal account, in order to assist Rua and Colonial in their scheme. The Court did not conclude in its Opinion and Order in Civil 87-1874 that the passbook account funds were used to pay Rua/Colonial debts. What the Court determined at page 9 of its opinion was that Colonial diverted over 11 million dollars from the custodial accounts held for Bowery, deposited them in an operational fund at Caguas, and used these diverted funds to pay its own and Rua's debts. It is precisely because the $ 500,000 in the passbook account were not spent, that the parties before the Bankruptcy Court are each claiming rights to these funds. [1]

We turn now to the facts underlying the Bankruptcy Court's opinion. The Court correctly determined that the $ 500,000 note evidencing the Rua obligation to Caguas was endorsed to the order of Banco Santander P.R. by RTC as Caguas' receiver and delivered to said bank as a result of the Purchase and Sale Agreement between RTC and Santander/CREFISA. It is undisputed that this note is a negotiable instrument to which the Uniform Negotiable Instruments Law (UNIL), 19 L.P.R.A. § 1, et seq., is applicable. It is also undisputed that CREFISA, Inc. is a holder in due course of that note. The dispute lies in the Bankruptcy Court's determination that the separate pledge agreement which serves as collateral to that note was not transferred by RTC to Banco Santander because

"with the simple transfer of the promissory note by mere endorsement and delivery, and the fact that the note is completely quiet as to the pledge, no evidence exists linking the two instruments during the actual assignment, e.g., existence of a separate document indicating assignment of the passbook account or an indication in the promissory note that the passbook provides collateral for the credit." The Court adds: "without any evidence indicating otherwise, **it can only be established that the intent of the parties was to transfer the promissory note and not the alleged pledge.**" (Emphasis ours.)

The Bankruptcy Court was also correct in following the established principle that a special act on the subject matter prevails over any other applicable rule of a general character. *Paris v. Canety, 73 P.R.R. 386, 388 (1952), St. Paul Fire & Marine v. Caguas Federal Savings, 121 D.P.R. 761, 766 (1988).* The inquiry, however, does not end there. The Bankruptcy Court limited itself to the facts corresponding to the transfer of the note or negotiable instrument via endorsement and delivery pursuant to the Uniform Negotiable Instruments Law, 19 L.P.R.A. § 61. However, appellant CREFISA, Inc. was involved in a contractual relationship with RTC involving the sale of Caguas' assets that went beyond the mere negotiation or transfer of the notes which evidenced the multiple Caguas' loans listed in the schedule of assets attached to the Agreement between them. That agreement, as will be discussed later, was never taken into account by the Bankruptcy Court upon ruling on the dispositive motion.

The Bankruptcy Court also rejected appellant's argument that the Uniform Negotiable Instruments Law recognizes in its Article 548, 19 L.P.R.A. § 386, that in any case not provided

for in said title, the rule of the law Merchant, Civil Law and Equity shall govern. See also Basilio Santiago-Romero, Tratado de Instrumentos Negociables, p. 30 (1981); *St. Paul, 121 D.P.R. at 766.* Appellant contends that the factual situation concerning the transfer of a collateral when the note which it secures is negotiated pursuant to the UNIL is a situation that is not governed by the legal dispositions of the UNIL. It therefore argues that, pursuant to § 386, one can resort to the applicable disposition of the Civil Code, 31 L.P.R.A. § 3943, which provides that: "The sale or assignment of a credit includes that of all the accessory rights, such as the security, mortgage, pledge, or privilege." The Bankruptcy Court understood that appellant incurred in "manipulation of the statutory provisions," and "was not entitled to expanded protection provided under Title 31" because he "must suffer the pitfalls of assignment by endorsement pursuant to Title 19." Opinion and Order of Bankruptcy Court, page 7. At page 6 of its Opinion and Order, the Bankruptcy Court invokes § 3273, 3282, and 3941 of the Civil Code, stating that "a Civil Code transfer warrants notarization of the assignments and execution in a public document containing a date certain," and "when that is accomplished, **the transfer is effective as against all third parties.**" (Emphasis ours.) The Court added immediately thereafter at page 7 that "where these steps are taken, the assignment of the note results in the assignment of all the accessory rights, including the security, mortgage, pledge or privilege, 31 L.P.R.A. § 3943."

It is apparent that the Bankruptcy Court conditioned the applicability of § 3943, which provides for the transfer of the security and other accessory rights together with the credit, to the prior compliance with § § 3273, 3282 and 3941 of the

Civil Code. The difficulty with this reasoning is that the three sections mentioned all deal with the effect of the assignment of credits **against a third party and the use of public instruments as evidence against a third person**. The situation before us involves both the relationship between RTC and CREFISA, Inc. and the contractual provisions which establish that relationship. CREFISA becomes a holder in due course of the $ 500,000 note precisely as a result of that contractual context. What, if anything, the parties intended as to the transfer of the collaterals securing the notes which evidenced the loans sold by RTC to Caguas must be found **within** the agreement of purchase and sale of assets which they executed in December 1990. The factual situation before us as to how or if the collaterals were transferred pursuant to their Agreement has nothing to do with the effect of the credits or the securities against third parties.

Therefore, § § 3273, 3282 and 3941 of the Civil Code, relied upon by the Bankruptcy Court, all of which deal with the effects against third persons, have no applicability. Nor did CREFISA, Inc. have to comply with "third party effect" requirements in order to claim the transfer of the collateral by RTC to it by virtue of the contract between RTC and Santander/CREFISA. By the same token, the applicability of § 3943 of the Civil Code does not necessarily depend upon the party having complied with § § 3273, 3282 and 3941 of Title 31 on the effect of the instrument or the assignment of the credit against a third person. This statutory provision applies if we confront a factual situation regarding a negotiable instrument, which is not covered by any legal precept in the UNIL. In our case, the issue is whether the collateral was transferred along with the note. Neither appellee nor the Bankruptcy Court explain why, in the

absence of legal precepts under the UNIL which would govern this type of situation, one cannot resort to the Civil Code as a source, as provided by Title 19 § 386 itself. Appellees have not cited any provisions in the special laws which address this particular situation, nor has the Court found any.

We conclude that § 3943 of the Civil Code, which provides that the sale of a credit transfers accessory rights along with it, is applicable. We therefore determine that, **pursuant to § 3943**, when RTC sold to Santander Bank the $ 500,000 note evidencing the Rua loan obligation to Caguas, it also transferred the $ 500,000 passbook account which he pledged as security for that debt in 1986.
Our inquiry does not end here, however. As in *Paris v. Canety, 73 P.R.R. 386,* the Court must look to the contract between the parties to determine whether they may have intended otherwise. In Paris, although the Court was applying strictly UNIL, it probed into the contract of sale to determine the parties' intention.

In deciding the controversy, the Court in Paris considered both the applicable statutory provisions and the contractual terms. In this case, however, the Bankruptcy Court ruled on what it considered to be the intention of the parties without ever considering the contract between RTC and CREFISA, Inc. for the sale of all the assets of the defunct Caguas. In its Opinion and Order, at page 10, the Court observed that "without any evidence indicating otherwise, it can only be established that the intent of the parties was to transfer the promissory note and not the alleged pledge." We understand that the Agreement of Sale and Purchase of Caguas' assets is

the evidence which indicates the intent of the parties to transfer the promissory note **and** the pledge.

A review of the entire contract between RTC and Santander/CREFISA reflects that the parties' intention was to transfer the negotiable instruments involved as **secured** obligations. Their awareness of the existence of the collaterals is manifest in the various clauses of the contract which we mentioned before. As stated earlier, however, clause 4.2(j) expressly provides that "the bank agrees to abide by and be bound by all of the terms and conditions of the Notes and other agreements related to the Assets purchased hereunder. The Bank further agrees to acknowledge and reaffirm all agreements affecting the Collateral, including without limitation, leases, security agreements, development agreements and restrictive covenants." As a consequence thereof, Santander/CREFISA agreed to acknowledge and reaffirm the pledge agreement involving the $ 500,000 passbook account as security or collateral to the Rua note. Under Article 4.2(j), it was bound to do so as to this or any other collateral related to the assets purchased under its Asset Purchase and Sale Agreement with RTC entered into on December 21, 1990.

Accordingly, the Motion Requesting Dismissal of Appeal filed by appellee Trustee Hans Lopez Stubbe and Bowery Savings Bank (**docket entry 19**) is DENIED. The Judgment entered by the Bankruptcy Court on February 22, 1995, pursuant to the Opinion and Order issued on January 25, 1995 dismissing CREFISA, Inc.'s adversary proceeding and granting appellee's motion to dismiss/summary judgment for lack of standing is REVERSED. Judgment shall be entered accordingly.

SO ORDERED.

At San Juan, Puerto Rico, on September 11, 1998.

CARMEN CONSUELO CEREZO

Chief, U.S. District Judge

JUDGMENT

Pursuant to the Opinion and Order issued on this same date, the Judgment entered by the Bankruptcy Court on February 22, 1995 dismissing CREFISA Inc.'s adversary proceeding and granting appellee's motion to dismiss and/or summary judgment for lack of standing is REVERSED.

SO ORDERED AND ADJUDGED.

At San Juan, Puerto Rico, on September 11th, 1998.

CARMEN CONSUELO CEREZO

Chief, U.S. District Judge

----------Footnotes----------

n1 We note that Bowery became Caguas' judgment creditor after title to Caguas' assets had already been conveyed to Santander pursuant to the agreement with RTC, and that Rua never paid the $ 500,000 loan which Caguas disbursed and which he secured by pledging the Passbook Account.

LEXSEE 1991 U.S. Dist. LEXIS 21717

THE BOWERY SAVINGS BANK, Plaintiff, v. COLONIAL MORTGAGE BANKERS CORPORATION, et al., Defendants.

Civil No. RLA 87-1874 (JAF)

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF PUERTO RICO

1991 U.S. Dist. LEXIS 21717

October 31, 1991, Decided

November 5, 1991, Filed

COUNSEL:
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For RESOLUTION TRUST CORPORATION, receiver: Antonio J. Amadeo-Murga, Juez de Apelaciones, Unidad Especial de Jueces de Apelaciones, San Juan, PR.

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For THE BOWERY SAVINGS BANK, plaintiff: Francisco C. Santaella-Conde, Calle San Rodolfo 1793, Rio Piedras, PR.

For MILTON JUAN RUA, DENISE DE-MAURET-RUA, CONJ. PART. RUA-DE MAURET, defendants: Harry Anduze-Montano, San Juan, PR.

For BANCO SANTANDER PUERTO RICO, defendant: Ismael H. Herrero, III, Dubon & Dubon, San Juan, PR.

For BANCO FINANCIERO, defendant: Carlos R. Rios-Gautier, Hato Rey, PR.

For CAGUAS CENTRAL FEDERAL SAVINGS BANK OF PR, defendant: Moises Gomez-Rijos, Cond. El Centro I, Hato Rey, PR.

HANS LOPEZ-STUBBE, trustee: David Friedman, O'Neill & Borges, Hato Rey, PR.

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For BANCO FINANCIERO, cross-defendant: Carlos R. Rios-Gautier, Hato Rey, PR.

For CAGUAS CENTRAL FEDERAL SAVINGS BANK OF PR, cross-defendant: Moises Gomez-Rijos, Cond. El Centro I, Hato Rey, PR.

JUDGES:
JOSE ANTONIO FUSTE, U. S. District Judge.

OPINIONBY:
JOSE ANTONIO FUSTE

OPINION:

OPINION AND ORDER

Plaintiff Bowery Savings Bank ("Bowery") commenced this diversity action against defendants Colonial Mortgage Bankers Corporation ("Colonial"), Milton Rua, the president of Colonial, his spouse and the conjugal partnership formed by them, as well as against Banco Financiero ("Financiero"), Caguas Central Federal Savings Bank ("Caguas"), and Banco Santander de Puerto Rico ("Santander"). [1] Also, because Colonial filed for relief under Chapter 11 of the Bankruptcy Code one week after this suit was commenced, the operating trustee, Hans Lopez Stubbe, became a party defendant to the action. [2] Plaintiff has raised various claims including breach of contract and alleged violations of Article 1802 of the Civil Code of Puerto Rico, 31 L.P.R.A. § 5141. [3]

Before the court are numerous motions for summary judgment. Plaintiff has moved for summary judgment against Colonial, Rua, and his spouse arguing that defendants have breached the mortgage servicing contracts entered into between Colonial and plaintiff. Bowery also raises claims for breach of fiduciary duty and for conversion as to assets collected by Colonial in its capacity as a mortgage servicer. Plaintiff has also filed separate motions against both Financiero and Caguas alleging that both banks were negligent and breached a fiduciary duty owed to Bowery in their management of Colonial's bank accounts maintained at both institutions. Caguas has cross-moved for partial summary judgment against plaintiff and the trustee arguing

that the latter parties have failed to allege sufficient facts to state a cause of action. The trustee has also filed both a counterclaim against Bowery for breach of the obligation of good faith and cross-claims against Rua, his wife, the conjugal partnership, Financiero, and Caguas.

The court will now rule on these various motions seriatim.

I.

Factual Background

This action arose out of the relationship between plaintiff, a New York banking corporation, and Colonial, a Puerto Rico corporation involved in the financing and servicing of residential and commercial mortgages.

On August 20, 1975, and then again on March 18, 1980, plaintiff Bowery executed a mortgage servicing agreement with Lincoln Financial Mortgagees, Inc. ("Lincoln"), the predecessor-in-interest to Colonial. (Docket Document No. 134, Exhibit III). Pursuant to the agreement, Lincoln agreed to collect payments made on residential and commercial mortgages in Puerto Rico held or owned by Bowery and thereafter to remit payment to Bowery. Article 1, Section (d) of the agreement provided in relevant part:

> Funds to be Held in Trust. All funds collected by the Contractor shall be held by the Contractor (Lincoln) in trust for Bowery or mortgagor as their interests may appear until paid over to Bowery or applied by the Contractor in accordance with the terms of this agreement and Contractor shall deposit such funds pending disposition thereof in accordance with this agreement, in trust

> accounts in a bank whose deposits are insured by the Federal Deposit Insurance Corporation. Each such account shall be so designated as to disclose the custodial nature thereof and shall be maintained in such manner as to comply with the applicable rules and regulations of the Federal Deposit Insurance Corporation. Contractor's records shall clearly show the respective interest of Bowery and of each mortgagor in all such accounts.

Id. at 1-2. The agreement also contained a choice of law provision wherein the parties would construe the agreement according to New York law. Id. at 8.

In a Notice to Investors, defendant Rua announced that, as of October 31, 1983, he had purchased 100% of the outstanding shares of Lincoln which, in turn, terminated the interest of Lincoln Savings Bank, F.S.B. as majority shareholder. (Id., Exhibit VI). It was at this time that the corporate name of Lincoln was changed to Colonial.

Colonial serviced the mortgages in the following manner. Mortgagors would make their payments to the order of Colonial either by mail, in person at Colonial's office or in a lock-box at Banco Popular de Puerto Rico ("Banco Popular"). These checks would then be deposited at Banco Popular in a corporate account established by Colonial. The monies would then be transferred to accounts at Financiero and Santander that were "in trust for" Bowery. From there, Colonial would disburse funds to Bowery pursuant to the terms of the above-mentioned servicing agreement.

A Lincoln/Colonial account at Financiero, Account No. 903-300346, (hereinafter referred to as "Bowery Trust Account" or "Account # 903-300346") (Docket Document Nos. 192, 218 Exhibit IV), was opened on December 21, 1981. The account was entitled "Lincoln Financial Mortgagees, Inc. In Trust For Bowery Savings Bank and Various Mortgagors." [4] The agreement contained standard language outlining the obligations of the depositor and the bank, including the right of the latter, at its option, to refuse to comply "with orders for payments or withdrawals of funds from this account" only where "the bank receives a summons, service, order, injunction, foreclosure, attachment, lien or notice (herein designated "court order") which, in the opinion of the bank, affects the funds deposited in the account." (Id. at 4). There is no specific language in the agreement referring to Bowery, other than naming it in the account title, nor is there any provision either restricting Colonial's access to the deposited funds or establishing a contractual or fiduciary relationship between Financiero and Bowery. [5]

Sometime thereafter, Colonial, either through Rua himself or through other employees on Rua's instructions, began to make withdrawals of funds deposited in the Bowery Trust Account for purposes not in compliance with the servicing agreement. Before the court are the details of two such series of transactions.

The first had to do with a transfer of $ 515,000 from Account # 903-300346 to another one of Colonial's accounts at Financiero. A check had been presented for certification on this latter account which was in overdraft. The bank contacted Eugenio Steffens, Colonial's vice-president and comptroller, and informed him that a person wished to certify a check drawn on a Colonial account which did not have a

sufficient balance to cover the amount of the check. Steffens then ordered the transfer of funds from Account # 903-300346 by phone. The bank confirmed Colonial's verbal authorization in a letter to Steffens dated January 7, 1986 by Luis Torres, an assistant vice-president of Financiero. (Docket Document No 192, Exhibit XI).

The second set of transactions began on November 25, 1986 when, in a letter to Arturo Somohano, vice president in charge of commercial loans at Caguas, Rua requested a $ 500,000 loan. (Docket Document No. 195, Exhibit IV). Contrary to normal bank procedure, no loan application was completed nor was the request presented to a bank loan committee or to the board of directors for approval. In a deposition, Francisco Sanchez, an executive vice president at Caguas, explained that since Colonial and/or Rua had outstanding loans totalling more than $ 500,000, a loan request for any amount would have had to have been approved by the bank's loan committee. (Id., Exhibit V, Tr. at 52-53).

The following day Rua executed a promissory note due on demand in the principal amount of $ 500,000. (Id., Exhibit VI). Two days later, on November 28, 1986, Rua's loan was disbursed at the same time he deposited Colonial check No. 43201, drawn on the Bowery Trust Account (# 903-300346) into Caguas account No. 12-4-00705-1. The loan funds were then deposited into Caguas account No. 12-3-00738-8, a personal account of Rua's.

On the same day, Rua opened another account at Caguas. This account (# 12-2-1330) was a Golden Passbook Savings Account ("Golden"). The cover of the passbook gave as the name of the account "Colonial Mortgage Bankers, BSB Corp" [6] and showed a deposit for $ 500,000 made on

November 28, 1986. (Id., Exhibit X). Rua used a check from his personal account (# 12-3-00738-8) to make the deposit. He also pledged the funds deposited in the Golden account as security against the 500,000 loan earlier obtained from Caguas. (Docket Document No. 200, Exhibit 5). Although the passbook already was in the name of Colonial, on December 12, 1986, Rua requested that account No. 12-2-1330 be transferred into the name of "Colonial Mortgage Bankers B S Inc." (Id., Exhibit 7) and submitted a corporate resolution dated December 8, 1986 authorizing Steffens to change the name on the account. (Id., Exhibit 8). [7]

Twice during 1987, in confirmation letters to Colonial's external auditor, Touche Ross, Caguas identified the Golden account as "Colonial Mortgage Bankers, BSB Corp." (Docket Document No. 195, Exhibits XIII, XIV). Also, in a deposition by Radames Alvarez Melendez, a partner at Touche Ross, he testified that he was informed by management at Colonial that the "BSB" in the account name represented Bowery. Id., Exhibit XV at 36-37). However, despite these representations, in a May 17, 1988 memo to Francisco Rios, vice-president of Caguas' Commercial Credit department, Octavio Rodriguez, manager of the Caparra branch of Caguas, returned the signature card for account # 12-2-1330 stating that it was the bank's policy ("politica de la institucion") not to open savings accounts for corporations. (Docket Document No. 200, Exhibit 9). This memo, written seventeen months after Rua's request in December 1986, presumably represented the bank's response to the request and meant that the account remained a personal account of Rua's, notwithstanding Caguas' representations to auditors that the account was a Colonial account.

Bowery first became aware that funds were improperly withdrawn from the Bowery Trust Account (# 903-300346) on December 8, 1987 when Antonio Quion, assistant treasurer at Bowery, was informed that six checks totalling $ 324,403.65 drawn by Colonial to the order of Bowery and Bowest [8] were returned for insufficient funds in the Financiero account. Rua's explanation for the checks "bouncing" was that Financiero had improperly removed funds from the account to cover an overdraft in another Colonial account.

Plaintiff also submitted the affidavit of Victor Alvear, a Certified Public Accountant with Ernst & Whinney, the accounting firm hired by Bowery to investigate Colonial's activities. (Docket Document No. 134, Exhibit VIII). On December 10, 1987, Alvear went to Colonial's office to review the latter's records relating to the Bowery trust accounts (the other account being at Santander). He reviewed the bank statements of the two accounts for the period from September 1, 1987 through October 31, 1987 and the canceled checks and mortgages from the Financiero account from July 1, 1987 through October 31, 1987. He found that a majority of the checks, totalling hundreds of thousands of dollars, had been made payable to Colonial and, rather than being remitted to Bowery or Bowest, had been deposited into Colonial accounts at either Caguas or Banco Popular. When questioned by Alvear as to why withdrawals were made from the Financiero account, Steffens replied that he did not know the reason but had been instructed to draw on the account by Rua.

The next day, December 11, 1987, Alvear and Edward Grebow, executive vice president of Bowery, met with Rua.

According to the affidavits of both Alvear and Grebow, at the meeting Rua admitted to having withdrawn over one million dollars from the Financiero account which was neither returned to the account nor remitted to Bowery. Rua's explanation for the withdrawals was that $ 420,000 were needed by Colonial to cover a default loan and that another $ 600,000 were used to pay both his and Colonial's debts. (Id., Exhibit II at P 7). After reviewing Colonial's records, Grebow and Alvear determined that the sum owed Colonial was at least $ 1,086,000. This same amount was included in Colonial's amended Schedule A-3 submitted to the bankruptcy court as part of Colonial's Chapter 11 reorganization.

Over the next week, a series of meetings were held between Grebow, Rua, and the latter's attorneys seeking to concur in a repayment plan whereby Colonial and Rua would repay the debt owed Bowery. No agreement was reached and, later in the month, this action commenced.

In a report dated May 24, 1988, the Puerto Rico Commissioner of Financial Institutions determined that, in the period between July 1, 1987 and November 10, 1987, Colonial transferred $ 11,846,880 from three custodial accounts and deposited them in an operational fund at Caguas. (Id., Exhibit V at 2). According to the report, these monies were used to make payroll payments, to finance a construction project, and to pay remodeling costs both on Colonial's office building and Rua's home. The report also stated that of the more than eleven million dollars withdrawn, $ 8,372,744 had been redeposited leaving a balance of $ 3,474,136 to be repaid. Id. This report also found that, during the period January 26-29, 1988, after Colonial had filed for

bankruptcy, two employees, under instructions from Rua, had disposed of documents relating to Colonial's activities. This was done without authorization by either the Commissioner or the bankruptcy court Id.

II.

Summary Judgment Standard

Before the court are various motions for summary judgment pursuant to Fed. R. Civ. P. 56. A court should grant a motion for summary judgment "if the pleadings, depositions, and answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c); *Lipsett v. University of Puerto Rico, 864 F.2d 881, 894 (1st Cir. 1988).* The two inquiries which the court must make before granting or denying a motion for summary judgment relate to the materiality and the genuineness of the factual dispute. See *Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247-48, 91 L. Ed. 2d 202, 106 S. Ct. 2505 (1986); Sheinkopf v. Stone, 927 F.2d 1259, 1261 (1st Cir. 1991); Local No. 48, United Brotherhood of Carpenters & Joiners v. United Brotherhood of Carpenters & Joiners, 920 F.2d 1047, 1050 (1st Cir. 1990); Garside v. Osco Drug, Inc., 895 F.2d 46, 48 (1st Cir. 1990).*

In order to determine whether the factual dispute between the parties is "material", the substantive law will identify which facts are material. "Only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment. Factual disputes that are irrelevant or unnecessary will not be counted."

Anderson, 477 U.S. at 248; Sheinkopf, 927 F.2d at 1262; See generally 10A C. Wright, A. Miller, & M. Kane, Federal Practice and Procedure § 2725 at 93-95 (1983). The substantive law of both Puerto Rico and New York (as it relates to the interpretation of the mortgage servicing agreements) will provide the basis for determining which facts are "material" in this case.

The second determination relates to the "genuineness" of the dispute about the material facts. In *Anderson v. Liberty Lobby, 477 U.S. at 248,* the court explicitly stated that a dispute is genuine "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." It is not required that the party opposing summary judgment, in asserting the existence of an issue of material fact, resolve it conclusively in order to proceed to trial, but rather that "sufficient evidence supporting the claimed factual dispute be shown to require a jury or judge to resolve the parties' differing versions of the truth at trial," *First Nat. Bank v. Cities Service Co., 391 U.S. 253, 288-89, 20 L. Ed. 2d 569, 88 S. Ct. 1575 (1968),* thereby resolving the factual issues "before the related legal issues can be decided." *Mack v. Great Atlantic and Pacific Tea Co., 871 F.2d 179, 181 (1st Cir. 1989); Sheinkopf, 927 F.2d at 1262.*

Further, when a motion for summary judgment is made, it is important to be precise as to the parties' burdens of production and persuasion.

> The burden of establishing the nonexistence of a "genuine issue" is on the party moving for summary judgment. This burden has two distinct components: an initial burden of

> production, which shifts to the nonmoving party if satisfied by the moving party; and an ultimate burden of persuasion, which always remains on the moving party. The court need not decide whether the moving party has satisfied its ultimate burden of persuasion until the Court finds that the moving party has discharged its initial burden of production.

Celotex Corp v. Catrett, 477 U.S. 317, 331, 91 L. Ed. 2d 265, 106 S. Ct. 2548 (1986) (citations omitted); 10A Wright, Miller & Kane, § 2727. The initial burden of production imposed on the moving party is to make a prima facie showing that it is entitled to summary judgment and, where it is the moving party who will have the burden of persuasion at trial, the motion must be supported by credible evidence "that would entitle it to a directed verdict if not uncontroverted at trial." *Celotex, 477 U.S. at 331.* Only then does the burden of production shift to the party opposing the motion. Where it is the nonmoving party who will have the burden of persuasion at trial, the moving party may satisfy Rule 56's burden of production in one of two ways.

> First, the moving party may submit affirmative evidence that negates an essential element of the nonmoving party's claim. Second the moving party may demonstrate to the court that the nonmoving party's evidence is insufficient to establish an essential element of the nonmoving party's claim. See 10A Wright, Miller & Kane § 2727, pp. 130-131; Louis, Federal

Summary Judgment Doctrine: A Critical Analysis, *83 Yale L.J. 745, 750 (1974).*

Celotex, 477 U.S. at 331. When the moving party chooses the second option and moves for summary judgment on the ground that the nonmoving party -- who will bear the burden of persuasion at trial -- has no evidence, the moving party "must affirmatively show the absence of evidence in the record." *Celotex, 477 U.S. at 331-32.* Throughout this analytical process, any doubt as to the existence of a genuine issue of fact should be resolved against the moving party, *Adickes v. S.H. Kress & Co., 398 U.S. 144, 158-59, 26 L. Ed. 2d 142, 90 S. Ct. 1598 (1970),* and courts "must review the evidentiary record in the light most hospitable to the nonmovant and must indulge all reasonable inferences in his favor." *Sheinkopf, 927 F.2d at 1262.*

Here, the underlying facts about what transpired are not in dispute. Only their interpretation remains. Therefore, summary judgment is the appropriate mechanism to decide the issues before us and we now proceed to rule on the various motions.

III.

Discussion

A. Bowery's Motions

1. Colonial and Rua

Bowery has raise claims for breach of contract, breach of fiduciary duty, negligence and conversion based on the diversion of funds from the Financiero account. In his opposition, defendant trustee seems to concede that Colonial and Rua did, in fact, breach the servicing agreements.

(Docket Document No. 150, Memorandum of law at 2). Rather than challenge the facts as outlined above, both the trustee and Rua hinge their arguments on the sufficiency of the affidavits and other documentary evidence accompanying plaintiff's summary judgment motion. Specifically, they challenge the affidavits of Grebow and Alvear, as well as the report from the Commissioner of Financial Institutions. As to the affidavits, they argue that the statements made were self-serving and conclusory and were themselves contradicted by deposition testimony. Further, they claim that the Commissioner's report was not properly authenticated. In addition, they raise an estoppel defense arguing that plaintiff failed to adequately supervise defendants' affairs and to bring to Colonial's attention that, from the commencement of the contractual relationship, the latter failed to maintain the proper type of trust accounts. Therefore, Bowery's own negligence should preclude it from recovery. Defendants argue that, because of plaintiff's "failure" to follow the precepts of Rule 56, as well as Bowery's own conduct, plaintiff is not entitled to summary judgment. We disagree.

First of all, we note that it is defendants themselves who fail to follow the mandates of Rule 56 in adequately opposing plaintiff's motion. Defendants do not set forth by affidavit specific facts showing that there is a genuine issue for trial as required by Fed. R. Civ. P. 56(a), nor do they submit affidavits as to why these facts were not forthcoming pursuant to Fed. R. Civ. P. 56(f). If is not until the trustee's surreply (Docket Document No. 177) that any evidentiary material or affidavit is submitted by defendants and the evidence submitted consisted solely in the deposition transcripts of Grebow and Royale. Nowhere do defendants challenge the facts regarding the diversion of the monies. As

the First Circuit has recently opined, "in the precincts patrolled by Rule 56, the decision to sit idly by and allow the summary judgment proponent to configure the record is likely to prove fraught with consequences." *Kelly v. United States, 924 F.2d 355, 358 (1st Cir. 1991).* While we must still rule on the merits of plaintiff's motion, see Kelly, id.; *Mendez v. Banco Popular de Puerto Rico, 900 F.2d 4, 7 (1st Cir. 1990),* plaintiff's factual allegations are basically uncontroverted and thus constitute the record upon which we must decide the motion.

Here it is clear that the 1980 service agreement required Colonial to maintain the mortgage funds in a separate account for the benefit of Bowery and to remit those funds directly to Bowery. The record also is clear that Colonial and Rua diverted funds which were to be remitted to Bowery. Both the November 1986 transactions and the Commissioner's report provide confirmation that funds were diverted from the Financiero account. The bankruptcy schedule reveals that Colonial is indebted to Bowery for more than one million dollars. Given these facts, we find that plaintiff has made out a prima facie breach of contract claim. Plaintiff's material factual allegations remain uncontroverted. Because we find that plaintiff has met its burden of persuasion under Rule 56, summary judgment for plaintiff is appropriate.

As to defendants' estoppel argument, we must first determine which state's substantive law applies. The servicing agreement calls for New York law to apply in the construction and interpretation of the agreement. The parties assume that Puerto Rico contract law applies. **[*25]** As a court sitting in diversity, we must apply Puerto Rico's conflict of laws rules to determine whether New York or Puerto Rico law applies. *Klaxon Co. v. Stentor Elec. Mfg.*

Co., 313 U.S. 487, 496-97, 85 L. Ed. 1477, 61 S. Ct. 1020 (1941); Slattery v. Bower, 924 F.2d 6, 9 (1st Cir. 1991). Since (1) the parties themselves chose New York law; (2) Bowery has sufficient contacts with the chosen forum; and (3) no overriding Puerto Rico policy rationale has been brought to our attention which might upset the parties' choice of New York law, see Unisys Puerto Rico, Inc. v. Ramallo Brothers Printing, Inc., 91 J.T.S. 69 at 8849, 8855 (1991); Restatement (Second) of Conflict of Laws 2d § 187 (1971 and 1989 Supp.); *Lummus Company v. Commonwealth Oil Refining Co., 280 F.2d 915, 924-25* (1st Cir.), cert. denied, *364 U.S. 911, 5 L. Ed. 2d 225, 81 S. Ct. 274 (1960),* we will look to the New York law of estoppel to determine whether it provides a defense for Colonial and Rua.

Under New York law,

> the general principle of equitable estoppel prevents one party from enforcing rights which would result in a fraud or injustice upon a second party who, in justifiable reliance upon the former parties' words or conduct, had been misled into acting upon the belief that such enforcement would not be sought.

Travellers International AG. v. Trans World Airlines, Inc., 722 F. Supp. 1087, 1098 (S.D.N.Y. 1989); Nassau Trust Company v. Montrose Concrete Products Corp., 56 N.Y.2d 175, 184; 436 N.E.2d 1265, 1269, 451 N.Y.S.2d 663 (1982). In order for defendants to successfully assert an estoppel defense, they will have to show that: (1) Bowery knew the facts regarding the true nature of the trust accounts and

Colonial's practice of withdrawals from these accounts for purposes not included in the servicing agreements; (2) Bowery, by its failure to challenge Colonial, acquiesced to the trust account arrangement and withdrawals; (3) Colonial was ignorant of both the requirement to maintain a trust account and its duty not to transfer funds from this account for purposes not specified in the servicing contract; and (4) Colonial and Rua relied on Bowery's acquiescence to their detriment. See *Rosenthal v. National Life Ins. Co., 486 F. Supp. 1018, 1023 (S.D.N.Y. 1980).* Applying this standard to the facts of this case, it is clear that defendants cannot assert an estoppel defense.

The key issue here is not the nature of the bank accounts (whether they were true trust accounts or not). It was the mortgage servicing agreement, and not the form of the bank account, which created Colonial's duty to Bowery. The gravemen of Bowery's complaint is that defendants diverted funds from these accounts for purposes not included in the servicing agreements. There are no facts before us showing that Bowery was aware that the diversions were taking place. Defendants produce no proof that Bowery acquiesced to the withdrawals made by Colonial and Rua nor do they come forward with any evidence showing injury to them as a result of Bowery exercising its right to enforce the servicing agreement. Under such circumstances, estoppel cannot apply.

Therefore, we grant plaintiff's summary judgment motion and find Colonial, Rua, his wife and the conjugal partnership liable for breaching the mortgage servicing agreements.

2. Banco Financiero

Bowery claims that Financiero was negligent and breached its fiduciary duty in the handling of Bowery funds

on deposit in the Colonial account. Also, Bowery alleges that Financiero's negligent conduct resulted in a wrongful set-off of $ 515,000 from the account when Financiero, upon instructions from a Colonial officer, transferred funds from one Colonial account to another to cover the certified check. Plaintiff argues that Financiero was on notice that the monies in the Financiero account were in trust for Bowery and that this knowledge coupled with certain practices allegedly engaged in by defendant to "accommodate" Colonial -- the granting of $ 1,700,000 in credit to Colonial and the covering of Colonial's overdrafts -- amounts to negligence on Financiero's part and entitles Bowery to summary judgment.

Financiero counters by arguing first of all that the checking account in question was an ordinary commercial checking account and was not established as a trust account for the benefit of Bowery. Further, Financiero argues that it always performed according to the terms of the account agreement entered into between Financiero and Colonial and always pursuant to the instructions of Colonial's officers. Also, defendant points out that in the period from January 1986, when the alleged wrongful set-off occurred, until late 1987, when Bowery became aware of Colonial's unauthorized transactions, it was business as usual between the parties. Thousands of checks passed through the Financiero account in question; the funds transferred in January 1986 were replaced; sums continued to be remitted by Colonial to Bowery, and Bowery's normal auditing procedures were in place to discover any potential wrongdoing. Thus, Financiero argues that Bowery has failed to establish a causal relationship between the January 1986 transaction and Bowery's alleged losses sufficient to establish the damage element of Article 1802, 31 L.P.R.A. 5141.

Given the record as it stands, we agree with defendant and find that Financiero is not liable under any of the theories proposed by plaintiff and, therefore, grant its motion for summary judgment dismissing the amended complaint as to Financiero.

We note at the outset that, as to Bowery's claims against Financiero (and Caguas), Puerto Rico law applies. We must, therefore, look to Puerto Rico banking law to determine whether the Colonial account at Financiero created a duty by the latter with respect to Bowery.

The parties do not dispute that the account agreement between Colonial and Financiero was a standard checking account contract.Under Puerto Rico law, the deposit of funds in a checking account establishes a debtor-creditor relationship between the depositary bank and the customer. Sec. of the Treas. v. Super. Ct.; Andreu, Int., [ILLEGIBLE TEXT] P.R.R. 648, 656 (1960); *Rodriguez v. Banco Popular, 66 P.R.R. 736 (1946); Treasurer v. Banco Commercial, 46 P.R.R. 298, 304-08 (1934).* In *Portilla v. Banco Popular, 75 P.R.R. 94, 106-08 (1953),* the Supreme Court of Puerto Rico discussed the relationship ("juridical bond") between a bank and a depositor.

> Our Civil Code characterizes the contract involved in the establishment of a current account ("cuenta corriente" or checking account) as a loan, and not merely as a deposit, since the depositary bank has, besides its obligation of keeping and restoring the money deposited,

> or its value, the authority of using or disposing of the thing deposited. . . . To regard such a relation as one which gives rise to a loan contract is in harmony with the prevailing rule in the United States of identifying said relation as one of debtor and creditor.

Portilla, 75 P.R.R. at 106-07 (citations omitted). "The obligations of banks to their depositors arise from the contractual relations existing between them" and are to be held "liable to its depositors when it make payments in violation of the latter's instructions." *P.R. Tob. Mkt. Ass'n v. P.R. & Amer. Ins. Co., 100 P.R.R. 386, 395 (1972).* In fact, Article 1116 of the Civil Code provides that "payment must be made to the person in whose favor the obligation is constituted or to another authorized to receive it in his name." 31 L.P.R.A. § 3166; *Portilla, 75 P.R.R. at 107-08.* Applying the above principles here, it is clear that Financiero had no contractual obligations with respect to Bowery. The banking contract did not create a trust ("fideicomiso") in favor of Bowery which would have made the parties subject to the trust provisions of the Civil Code, 31 L.P.R.A. § § 2541-2581. Nor did the account constitute a special deposit (as opposed to a general deposit) in favor of Bowery, see *Treasurer, 46 P.R.R. at 305-06.* [9] Also, Bowery does not claim that Steffens lacked authorization to draw on the account. [10] In fact, Financiero would probably have breached the checking account agreement if it had not executed the transfer upon Steffens order. It is clear, therefore, that there can be no contractual basis for Bowery's claim.

However, a bank can also be found negligent under Article 1802, 31 L.P.R.A. § 5141. See *Federal Insurance Co. v. Banco Popular de Puerto Rico, 750 F.2d 1095 (1st Cir. 1983).* Plaintiff relies on Federal Insurance Co. for the proposition that a bank should be held liable under Article 1802 for the misappropriation of trust assets by the fiduciary if the bank both knows the true character of the deposited funds and acts negligently as to those funds. In Federal Insurance Co., the employee of the corporate depositor acted without the consent of the corporation in embezzling corporate funds to pay personal debts. *750 F.2d at 1097.* The reason that the bank was found negligent was that, despite numerous irregularities -- the amount and frequency of the diversions, as well as the use to which the diverted funds were put (paying the embezzler's personal credit card debts to the bank) -- the bank failed to inquire as to the employee's authority to divert corporate funds into personal accounts.

Here it was Colonial itself, through Steffens, that authorized the transfer of funds from one to another of its corporate accounts. The fact that Colonial (or its employees) may have been breaching the mortgage servicing agreement by making such a transfer, under the facts presented, could not have been known by Financiero. Defendant was the depository bank for nineteen of Colonial's corporate accounts. Thousands of transactions occurred involving Colonial. To expect Financiero to monitor each of Colonial's transactions would have placed an impossible burden upon the bank. As do both sides in their memoranda of law, we quote and adopt the position found in Michie on Banks and Banking which describes the situation before us.

In the absence of notice or knowledge that a breach of trust is being committed by an improper withdrawal, a bank cannot question the right of its customer to withdraw funds, nor refuse to honor his demands by check; and therefore, even though the deposit is to customer's credit in trust, the bank has no obligation to look after the appropriation of the trust funds when withdrawn or to protect the trust by setting up a "jus tertii" against a demand. If a fund be deposited in bank by one as trustee, the depositor as trustee has the right to withdraw it, and the bank, in the absence of knowledge or notice to the contrary, would be bound to assume that the trustee would appropriate the money, when drawn, to a proper use. And the bank must honor his checks, when in proper form, unless it then has actual or constructive knowledge that he is by means thereof intending to wrongfully divert the trust funds. Any other rule would throw upon a bank the duty of inquiring as to the appropriation made of every fund deposited by a trustee or other like fiduciary; and the imposition of such a duty would practically put an end to the banking business, because no bank could possibly conduct business if, without fault on its part, it were held accountable for the misconduct or malversations of its depositors who occupy some fiduciary relation to the fund placed by them with the bank.

5A Michie on Banks and Banking § 57c at 197-201 (1983) (emphasis added).

Here, as we have already established, the Financiero account was not a trust account. While the mortgage servicing agreement created duties between Bowery and Colonial, the Financiero account contract created the normal debtor-creditor relationship with its customer Colonial. Financiero had no special duty to Bowery. Given the facts here, we simply do not find that Financiero had notice that Colonial and its officers were misappropriating Bowery funds. Without such notice and, in the absence of a specific contractual relationship or the establishment of a specific duty on Financiero's part, the depository bank cannot be held liable for the sins of its customers. We, therefore, grant Financiero's summary judgment motion and dismiss the amended complaint as to Financiero. Accordingly, we deny Bowery's summary judgment motion as to Financiero.

3. Caguas

Bowery argues that Caguas is liable based on its participation in the November 1986 series of transactions which resulted in $ 500,000 being withdrawn from the Financiero account and ending up in one of Rua's personal accounts. Plaintiff argues that the granting of the loan was a "simulated contract" ("contrato simulado") whose purpose was to deceive and defraud third parties from the true nature of the action -- the diversion of funds -- and, as such, is void under Puerto Rico law. Bowery also raises a breach of fiduciary duty and an Article 1802 violation as additional bases for Caguas' liability.

Caguas does not challenge the underlying facts as outlined above. Nor do they produce evidence to contradict plaintiff's version of the facts, most notably any admissible evidence showing approval of the loan by the bank. They seek to avoid summary judgment by disputing the title to account number 12-2-1330 arguing that the account was in Rua's, and not Colonial's name.

Here, unlike the situation with Financiero, the court agrees with Bowery that Caguas has violated Article 1802 of the Civil Code by the negligent facilitation of Colonial and Rua in the diversion of funds belonging to Bowery and by making misrepresentations regarding the loans to bank auditors.

The record is clear that the bank did not follow its usual procedures in evaluating and approving the November 1986 loan. There is no record of even an application being completed by Rua. In deposition testimony different personnel at Caguas, while admitting involvement in the processing of the "loan" agreement, do not admit authorizing the loan nor could they remember who, in fact, did authorize it. n11 It is also clear from the record that the only funds that were actually used to secure the loan came from the Bowery Trust account. And it was Caguas that confirmed to Touche Ross auditors that the funds in the Golden account were held for Bowery's benefit, even though Caguas bank officials later contradicted these statements in the May, 1988 memo and claimed that the Golden account was always a personal account of Rua's and could never have been converted into a corporate account because of bank policy. No explanation is given as to why, in light of this "bank policy," the Golden account was entitled a Colonial account.

From these facts it has been established that Caguas knew or should have known that: (1) Colonial and Rua were involved in unusual banking activities; (2) the funds used by Colonial to further the scheme belonged to and were held in trust for Bowery; and (3) the result of the transaction was to misappropriate funds held in trust. Again, as a treatise on banking law opines:

> A bank is liable when it has actual or constructive knowledge that a fraud is being or is about to be perpetrated by the fiduciary, and assists him in making a misappropriation of the trust funds. It is held that to render the bank liable it must have actually participated in the misappropriation, or with knowledge reaped some benefit therefrom.

5A Michie § 57e at 208-11. Here, the facts evidence Caguas' negligent participation in and knowledge of the scheme. Under the reasoning of *Federal Ins Co., 750 F.2d at 1098-99,* the bank can also be held liable for failing to inquire as to the nature of the funds in the Bowery Trust account. Not only did Caguas not inquire, but it actively assisted Colonial in misrepresenting the true nature of the funds to Bowery auditors. This evidence remaining uncontroverted, plaintiff, is entitled to judgment as a matter of law.

The trustee for Colonial also opposes plaintiff's summary judgment motion while, at the same time, arguing that Caguas is liable to Bowery. (Docket Document No. 213). The trustee's position is that the funds in question were not true trust funds nor traceable to such funds. They remain assets of

Colonial and subject to administration by the trustee in bankruptcy. Therefore, the trustee reasons that, while Bowery is entitled to judgment for $ 500,000 against Caguas, the balance in the Golden account itself is part of the Colonial's estate and should be administered under the Bankruptcy Code. They therefore seek that any judgment entered against Caguas be placed with the bankrupt's estate.

Given the basis for our decision as to Caguas' liability to Bowery -- a violation of Article 1802 -- we disagree with trustee's position. Here Colonial, Rua, and Caguas are joint tortfeasors. Under Puerto Rico law, where joint tortfeasors are each found liable, they become jointly and severally liable, Ramos v. Caparra Dairy, Inc., 1985 PR Sup. LEXIS 45, *116 D.P.R. 60, 63 (1985);* Torres v. A.F.F., 1967 PR Sup. LEXIS 222, *94 D.P.R. 314 (1967),* and the injured party can bring an action against any or all of them. *Hanover Insurance Company v. Liberian Oceanway Corp., 398 F. Supp. 104,109 (D.P.R. 1975).* However, Puerto Rico law also dictates that a negligent party can only be found liable to the extent of the damage caused by their negligence. *Ramos, 116 D.P.R. at 62.*

Consequently, having found Caguas jointly and severally liable with Colonial and Rua, Bowery can claim directly against any or against all of the defendants. The damages Bowery receives result from Caguas' own negligent acts and not from its status as constructive or actual trustee of a Colonial account made up of diverted funds from Bowery. As such, plaintiff's claim can be satisfied from the assets of Caguas and does not have to be satisfied by recouping the monies in a Colonial account. If the latter were the case -- that Bowery only had the right to claim against Colonial

accounts at Caguas -- then there would be a question as to whether the monies satisfying the judgment were part of the bankrupt's estate. Here, Bowery is entitled to execute the judgment of this court directly against Caguas.

However, as to Caguas' liability, $ 500,000 would be the extent that Bowery could claim against defendant based on the proof before the court. In a separate motion, Caguas seeks summary judgment dismissing Bowery's amended complaint and the trustee's cross-claim against it with respect to all transactions with the exception of its participation in the $ 500,000 loan transaction. Plaintiff has come forward with no evidence of other negligent acts on the part of Caguas. Accordingly, for the same reasons stated above relating to Financiero, we agree with Caguas that its liability should be limited to the damage caused Bowery by its participation in this transaction.

Therefore, we grant Bowery's summary judgment motion and find Caguas liable to Bowery in the amount of $ 500,000.

B. Trustee's Cross-Claims and Counterclaims

We have now ruled on all of the dispositive motions before us. We note, however, that the trustee has also filed a counterclaim against Bowery and cross-claims against Rua, his spouse, Financiero, and Caguas. (Docket Document No. 159). Although we have no dispositive motions before us as to these claims, we think the circumstances of this case (and the concurrent Colonial bankruptcy proceedings), the factual allegations presented in the trustee's claims, and our rulings as to the dispositive motions provide a basis to rule on the pending claims.

1. Trustee's Counterclaim against Bowery

The basis for the trustee's counterclaim against Bowery is that officials of the latter, after discovering the diversion of funds, held discussions with Rua in December 1987. Specifically the trustee refers to the meetings held the week of December 11, 1987 between Rua and Grebow, at which an alleged "agreement" was made with respect to the repayment of the diverted funds. The trustee's claim is that Bowery breached this "agreement" by commencing legal action later that month. We disagree.

At the time the "negotiations" were held, defendants admitted that they had breached the servicing agreements. The goal of the discussions was to remedy the breach, presumably without resort to litigation. Where the parties could not agree, Bowery exercised its right to seek relief through the courts. Consequently, we find that no separate oral contract was formed in which plaintiff agreed to forego litigation.

Therefore, we dismiss the trustee's counterclaim for failure to state a cause of action.

2. Trustee's Cross-claims

The trustee has raised claims for waste, mismanagement, misuse of customer accounts and deposits, breach of fiduciary duties as officers of Colonial, self-dealing, conspiracy and securities law violations against Rua, his spouse and Steffens. As to Financiero and Caguas, the trustee has raised a similar breach of duty claim to that raised by Bowery.

First of all, as to the claims against Caguas and Financiero, for the reasons stated in section III(A)(2) of this Opinion, we dismiss the trustee's cross-claims as to Bowery and Caguas.

As to the claims against the individual defendants, we note that this court has recently had before it two proceedings arising from the Chapter 11 reorganization of Colonial. *In re Colonial Mortg. Bankers Corp., 128 B.R. 21 (D.P.R. 1991);* In the Matter of Colonial Mortgage Bankers Corp., Civil No. 91-1733 (JAF) (D.P.R. Oct. 21, 1991). We simply note that the bankruptcy court has been intimately involved with the facts surrounding Colonial's bankruptcy reorganization and is in a far better position to efficiently and expeditiously adjudicate the trustee's claims if, in fact, they are properly within federal jurisdiction.

Therefore, pursuant to *28 U.S.C. § 157*(a), [12] we refer the trustee's cross-claims against Rua, his spouse and the conjugal partnership to the United States Bankruptcy Court for the District of Puerto Rico in conjunction with the on-going reorganization of Colonial. The bankruptcy court will, in turn, determine whether the trustee's claims are core or non-core proceedings, *28 U.S.C. § 157*(b)(3), and if the claims are found to be non-core or "related to" proceedings, the bankruptcy court should determine whether to hear the claims and "submit proposed findings of fact and conclusions of law" to this court as provided by *28 U.S.C. § 157*(c)(1) or should abstain from hearing the non-core matters, thus allowing the parties to sue in state court. *28 U.S.C. § 1334*(c). See *In re Arnold Print Works, Inc., 815 F.2d 165, 166-67 (1st Cir. 1987).*

IV.
Conclusion

Having reviewed the voluminous record and ruled on the various motions and claims, we now summarize our rulings.

1. We **GRANT** Bowery's summary judgment motion and find Colonial, Rua, his wife and the conjugal partnership liable for breaching the mortgage servicing agreements.

2. We **GRANT** Financiero's summary judgment motion and **DISMISS** the amended complaint as to Financiero. Accordingly, we **DENY** Bowery's summary judgment motion as to Financiero.

3. We **GRANT** Bowery's summary judgment motion and find Caguas liable to Bowery in the amount of $ 500,000.

4. We **DISMISS** trustee Hans Lopez Stubbe's counterclaim against Bowery for failure to state a cause of action.

5. We **DISMISS** the trustee's cross-claims as to Financiero and Caguas for failure to state a cause of action.

6. Pursuant to *28 U.S.C. § 157*(a), we **REFER** the trustee's cross-claims against Rua, his spouse and the conjugal partnership to the United States Bankruptcy Court for the District of Puerto Rico. We will retain jurisdiction over these claims only in the event the bankruptcy court finds that these causes of action represent non-core proceedings and elects to hear the matter and submit proposed findings of fact and conclusions of law to this court.

IT IS SO ORDERED.

San Juan, Puerto Rico, this 31st day of October, 1991.

JOSE ANTONIO FUSTE

U. S. District Judge

----------Footnotes----------

n1 As to Santander, a motion for dismissal by stipulation was filed by the parties and partial judgment was entered dismissing Santander from the action. (Docket Document No. 167).

n2 Although Colonial filed for Chapter 11 reorganization, no motion was filed by plaintiff pursuant to Local Rule 706 of the Local Rules of the United States District Court for the District of Puerto Rico informing the court of the applicability of the automatic stay provision, *11 U.S.C. § 362,* to the pending action. Nor during almost four years of litigation have any of the parties raised the issue. We, therefore, assume that a section 362 stay is not in effect with respect to the pending action.

n3 Article 1802 provides:

A person who by an act or omission causes damage to another through fault or negligence shall be obliged to repair the damage so done. Concurrent imprudence of the party aggrieved does not exempt from liability, but entails a reduction of the indemnity

31 L.P.R.A. § 5141 (1991).

n4 In a letter dated January 26, 1983, Luis Rosario, Assistant Comptroller for Lincoln, requested that the words "In Trust For Bowery Savings Bank" be changed to "I/T/F Bowery Savings Bank." (Id., Exhibit V).

n5 We note that by the 1986-1987 period, Colonial had thirty-four different bank accounts, nineteen of which were at Financiero and another five at Caguas. (Docket Document No. 220, Exhibit F at 20).

n6 We note that in the various documents submitted by plaintiff, the Golden account (# 12-2-1330) has various titles, some of which may simply have been typographical errors. However, the number of the account remained the same.

n7 Again we note that there is no explanation why Rua/Colonial sought to change the name of the account only two weeks after opening it. We do not have the original signature cards, but presumably the Golden account was opened as a personal, rather than corporate, account and these transactions were conducted to convert the account into the latter, notwithstanding that the name on the passbook implied that it was opened as a corporate account in the name of Colonial.

n8 A corporation set up by Bowery which also received mortgage payments from Colonial.

n9 In *Treasurer, 46 P.R.R. at 305-6,* the Supreme Court of Puerto Rico explained the difference between a general and special deposit.

In the first title to the thing deposited passes to the bank. In a special deposit, the title remains in the depositor. When money or other property is deposited in a bank with the understanding that the identical money or property is to be returned, the deposit it is a special one.

The court went on to discuss a certificate of deposit to be paid to the benefit of a third party and found that such a certificate carries with it "the presumption of a general deposit." *Id. at 318.* Here there is no evidence before the court that it was the intention of Colonial to create a special deposit type of account at Financiero. In fact, given the nature of Colonial's business, it would have been impracticable to set up a special deposit account where Colonial had to make many banking transactions in order to fulfill its duty to its clients.

n10 Here we are not inferring that Steffens' order transferring funds from the Financiero account may not have breached the mortgage servicing agreement. However, as regards the bank, he had authorization to execute transactions on the Financiero account.

n11 Arturo Somohano, the Caguas officer in charge of commercial lending, denied granting the loan. (Docket Document No. 195, Exhibit XVII). Roberto Diaz, Somohano's assistant, who authorized the disbursement, likewise, testified that he did not recall participating in the transaction itself. (Id., Exhibit XVIII). And Ross Diaz, the Caguas official who actually disbursed the loan, could not recall whether it was Somohano or Diaz who authorized it. (Id., Exhibit XIX).

n12 Section 157 (a) provides:

Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.

28 U.S.C. § 157(a).

IN RE: COLONIAL MORTGAGE BANKERS CORPORATION, Debtor. CREFISA INCORPORATED, Plaintiff, v. WASHINGTON MUTUAL BANK, F.A., Defendant, HANS LOPEZ-STUBBE, TRUSTEE,

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF PUERTO RICO

Case No. 87-03026
Dated 1/25/95

Before the Court is a Motion to Dismiss or for Summary Judgment for Lack of Standing (docket No. 8) filed by defendants, the Trustee for Colonial Bankers Mortgage Corp. (Colonial) and The Bowery Savings Bank (Bowery) on April 24, 1994. Plaintiff Crefisa, Inc. (Crefisa) filed its Opposition (docket No. 11) on May 4, 1994. Thereafter a defendants - submitted-a-Reply-(docket-No . 14, filed on May 17 1994) and Plaintiff submitted a Surreply (docket No. 15, filed on June 9, 1994). For the reasons discussed below, defendants motion for summary judgment is granted and this action is hereby dismissed.

I. BACKGROUND

The specific facts related to the immediate dispute are uncontested At issue is the ownership of a five hundred thousand dollars ($ 500,000) Golden Passbook Account (passbook account) drawn from a check issued from a personal bank account and deposited with the now defunct Caguas Federal Savings Bank (Caguas) by Mr. Milton Rua, President of Colonial on November 28, 1986.fn1 On that same date, Mr. Rua received a loan for the amount of five

hundred thousand dollars ($500,000) from Caguas as witnessed by promissory note payable on demand. A separate letter indicate that the passbook account collateralized the loan. see Memorandum docket No. 10, exhibit No. 1.

While the promissory note as well as the check were issued Mr. Rua's name, the facts indicate that the funds were used to pay Mr. Rua's debts as well as those of Colonial.fn2 Approximately one year later in December, 1987, Colonial filed for bankruptcy.fn3

During May and August, 1990, respectively, the Resolution Trust Corporation (RTC) was appointed conservator and receiver to Caguas. Consequently, the RTC substituted Caguas on the promissory note for the five hundred thousand dollars---($500,000)--held --by Caguas. Thereafter, the credit was endorsed to the order of Banco Santander Santander) which, in turn, assigned it by endorsement to plaintiff Crefiza.

The question before this court is whether the assignment of the promissory note effectively resulted in the transfer of the passbook account which served as collateral to the note.

II. SUMMARY JUDGMENT STANDARD

Bankruptcy Rule 7056 makes Rule 56 of the Fed. R. Civ. P. applicable to adversary proceedings. Utilizing the standards articulated by the Supreme Court in construing Rule 56, summary judgment is warranted where, after adequate time for discovery and upon motion a party fails to establish the elements essential to its case and upon which it

carries the burden of proof at trial. Celotex corp. v. Catrett, 477 U.S. 317, 322 (1986).

When considering a petition for summary judgment, the Court must view he evidence in the light most favorable to the nonmoving party. Poller v. Columbia Broadcasting Systems, Inc., 368 U.S. 464, 473 [962); Daily v Smith, 842 F.2d 9, 11 (1st Cir. 1988). The moving party is required to demonstrate that- -there - -is- an-absence of evidence supporting the nonmoving party's case, Celotex, 447 U.S. at 325. See Prokev v. Watkins, 942 F.2d 67, 72 (1st Cir. 1991); Daury, 842 F.2d at 11.

The moving party invariably bears both the initial as well as the ultimate burden in demonstrating its legal entitlement to summary judgment Adickes v. Kress & Co., 398 U.S. 144, 157 (1970). See also Lopez v. Corporacion Azucarera de Puerto Rico, 938 F.2d 1510, 1516 (lst Cir. 1991). It is essential that the moving party explain its reasons for concluding that the record does not contain any genuine issue of material fact in addition to making a showing of support for those claims for which it bears the burden at trial. Bias v. Advantage International. Inc., 905 F.2d 1558, 1560-61 (D.C.Cir.), cert. denied, 498 U.S. 958 (1990).

Accordingly,the moving party must "show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c). For there to be a "genuine" issue, facts which are supported by substantiantial evidence must be in dispute, thereby requiring deference to the finder of fact. Furthermore, the disputed facts must be material" or determinative of the outcome of the litigation Hahn v.

Sargent, 523 F.2d 461, 464 (1st Cir. 1975), cert. denied, 425 U.S. 904 (1976).

III. DISCUSSION

Defendants assert that even when viewing the facts most --favorable to the plaintiff and not questioning the validity of the assignment summary judgment should be granted and this action should be dismissed because plaintiff has failed to meet its burden by presenting direct evidence of the actual assignment of the collateralfn4 Furthermore, defendants contend that the plaintiff's reliance upon particular provisions of the law are misplaced. We agree. -

Plaintiff argues several theories. First, it is alleged that the law merely requires valid assignment of the promissory note to effectuate the transfer of the collateral. Plaintiff relies upon 31 L.P.R.A Sec 3943 which reads as follows:

> The sale or assignment of a credit includes that of all the accessory rights, such as security, mortgage, pledge, or privilege

Admitting that no other evidence was produced except the promissory note wherein the endorsements are stamped and signed on the back of the promissory note pursuant to title 19, plaintiff justifies application of the Civil Code, section 3943, relying upon 19

L.P.R.A. Sec. 386. Section 386 of title 19 reads:

> In any case not provided for in this title the rule of the law Merchant, Civil Law and Equity shall govern.

In the alternative, plaintiff asserts that the passbook which serves as collateral is inextricably linked to the promissory note in the same manner as the security pledge to a mortgage loan. Accordingly where title to property secures a mortgage and the title is conveyed by endorsement, the mortgage right is automatically conveyed along with the title and there is no need to the debtor or formally register the conveyance. See 30 L.P.R.A. Sec 2614. Consequently, it is alleged, the legal consequences-of-assignment are the same in both instances.

A review of the laws in this jurisdiction reveal that transfer of credit can be accomplished in two ways. Accordingly, assignment may be completed pursuant to the Civil Code or the Uniform Negotiable Instruments Law. When making a comparison, the requirements for each method as well as the legal consequence, differ substantially.

Transfer of an instrument under the Uniform Negotiable Instrument Law, 19 L.P.R.A. Secs. 61-81, is fast and simple. An instrument is negotiated by delivery where it is payable to the holder, or by endorsement and delivery if payable to the order. See 19 L.P.R.A . Sec. 61. Furthermore, the endorsement need only be written upon the instrument itself or attached to the instrument and does at require anything more than the signature of the endorser. See 19 L.P.R.A. Sec 62. *See, also, National City Bank v. Echvarria,* 50 P.R.R. 825, 829 (1937).

Assignment pursuant to-the Civil Code, 31 L.P.R.A. SS 3941 3951 is more complicated and cumbersome but provides additional safeguard . A civil Code transfer warrants notarization of the assignment and execution in a public document containing a date certain. See 31 L.P.R.A. 55 3273, 3282, 3941. When that is accomplished , the transfer is effective as against all third parties. See 31 L.P.R.A. Sec 3941. In addition, while title 31 does not require the consent of the debtor, notification of the assignment is required. See 31 L.P.R.A. Sec. 3942. Where these steps are taken, the assignment of the note results in the assignment of all the accessory rights including the security, mortgage, pledge and privileges. *See* 31 L.P.R.A. Sec 3943

A review of the facts shows that the assignment of the promissory note was accomplished by a simple undated, unnotarized endorsement stamped and signed by the assignor on the back of the promissory note. Clearly, the method utilized by the assignors is consistent with the provisions of title 19.

Nevertheless, plaintiff attempts to reap legal advantages which flow from the operation of an assignment pursuant to the Civil Code . It is undisputed that the steps required under the Civil Code from which the legal consequences are derived have not been taken by plaintiff. However, plaintiff haphazardly applies particular provisions leading to very specific legal consequences of the alternative method which demands a far more rigorous procedure. Such manipulation of statutory provisions distorts the true intent of the statutory scheme resulting in a practice that cannot be condoned in any judicial forum. Accordingly, the plaintiff may claim he benefits and must suffer the pitfalls of

assignment by endorsement pursuant to title 19 and is not entitled to expanded protection provided under title 31.

In a addition, relying upon basic and established principles of statutory construction, the Supreme Court of Puerto Rico has held that assignment of promissory notes is governed by the Uniform Negotiable Instruments Act, title 19, rather than the provisions contained in the Civil Code, title 31. *Paris* v. Canety, 73 P.R.R. 386, 388 (1952) (the Uniform Negotiable Instruments Act is specialized and should prevail over the application of any general rule) .fn5 See , *also, Busic* v. *United States,* 446 U.S. 398, 406, 100 sect. 1747 1752, 64 L.Ed.2d 381 (1980); *Morton v. Mancari,* 417 U.S. 535, 650-51 94 sect. 2474, 2482-83, 41 L.Ed.2d 490 (1974) (same). Precedent supports the conclusion that Civil Code provisions, which create a separate and distinct statutory scheme, are not applicable to transfers of promissory notes completed under an entirely separate statutory scheme. Accordingly, plaintiff's argument must fail.

Furthermore plaintiff's conclusion seems all the more illogical when we consider that the instrument transferred is completely silent as to the collateral. Plaintiff asserts that it is well established law that collateral need not be explicitly identified in order for it to be assigned along with the credit. While such legal consequences may result where assignment is completed pursuant to Mortgage Law or the Civil Code, no legal basic was cited by plaintiff and/or found by the court to support the conclusion that this principle is applicable to "transfers -performed under the Uniform Negotiable Instruments fn.6

Insofar that the court has found that 1) the assignments at issue were not conducted pursuant to the provisions of *the* Civil Code and 2) the Supreme Court has rejected the notion that the Civil Code governs transfers of promissory notes, plaintiff's reliance upon the legal effect of 31 L.P.R.A. Sec. 3943 is misplaced. Furthermore, plaintiff's conclusion that the assignment of promissory notes are comparable to assignment of mortgages lacks merit.

Mortgages, by definition, are accessory in nature existing as security to a principal obligation as long as the obligation continues to be outstanding. *Liechty and Liechty v. Descartes,* 109 P.R.R. 660 667-68 (1980)(mortgage contract presupposes two legal concepts:
principal obligation and the mortgage itself, which serves as security to the former's creditor). The credit and the security interest are inseparable; without the principal obligation a mortgage would not exist. Liechty, 109 P.R.R. at 668-69.

The credit assigned here is a promissory note is devoid of any no reference to the collateral. Such instruments are not defined by and explicitly linked to secured interests so as to create the analogy to a mortgage as suggested by plaintiff No authority exists indicating that the mere existence of a collateralized promissory note and its assignment under title 19 results in application of established principles of law governing mortgages. Without establishing this crucial element, caselaw relied upon plaintiff is not dispositive. See, e.g., Mercado v. Oliviari, 60
P.R.R.856 , 864 (1942) (a mortgage is indivisible, thereby, resulting in assignment of the privileges contained in the deed with assignment of the mortgage credit) and RIOS V.
Registrador, 23 P.R.R. 634 (1916) (because the promissory

note was executed prior to the mortgage, the omission of reference to the mortgage it later secured does not constitute a curable defect for the purpose of recording the mortgage).

Accordingly, with the simple transfer of the promissory note by mere endorsement and delivery, and the fact that the note is completely quiet as to the pledge, no evidence exists linking the two instruments during the actual assignment, e.g., existence of a separate document indicating assignment of the passbook account or an indication in the promissory note that the passbook provides collateral for the credit. Without any evidence indicating otherwise, it can only be established that the intent of the parties was to transfer the promissory note and not the alleged pledge.

IV. CONCLUSION

Therefore no legal basis exists under the facts of this case which support the contention that the five hundred thousand dollar ($500,000) Golden Passbook Account was assigned to the plaintiff Crefisa, Inc. along with the assignment of the promissory note.

Defendants Trustee for Colonial Bankers Mortgage Corp. and The Bowery Savings Bank are entitled to judgment as a matter of law.

Accordingly, the Summary Judgment Motion (docket No. 8) filed by defendants Hans Lopez Stubbe, Trustee for Colonial Bankers Mortgage Corporation and The Bowery Savings Banks against plaintiff Crefisa, Inc. is hereby GRANTED and, the action is hereby DISMISSED.

The Clerk of the Bankruptcy Court shall enter final judgment.

SO ORDERED.

—

Chief U. S. Bankruptcy Judge

San Juan, Puerto Rico, this 20 day of January, 1995.

fn1Subsequently the passbook account was subject of a Bankruptcy Court Order issued on April 21, 1988 granting the trustee's request to turnover the sum of five hundred and six thousand and nine hundred and twelve dollars and fifty-seven cents (506,912.57) which allegedly belonged to Rua but was held by Colonial in the Caguas passbook account. In compliance with the order, Caguas issued a check in favor of the trustee in November, 1989 for the amount-of five hundred and fifty seven thousand and seven hundred and twenty dollars and eighty six cents ($557,720.86). See Complaint, filed on October 8, 1993, p. 2.

fn2 See the Bowery Savings Dank V. Colonial Mortgage. Bankers Corp., RLA A 87-1874 (JAF), issued on October 31, 1991, p. 9. Compare Memorandum of Law..., docket No. 10, filed on May 2, 1994, p. 2.

fn 3At about that time, an action was commenced in District Court; a stay was never requested and the court found that the $500,000 passbook account was actually monies fraudulently diverted from Bowery savings Bank and that Rua, Colonial and Caguas were jointly and severally liable to Bowery for damages in that amount. See The Bowery Savings Bank V. Colonial Mortgage Bankers Corp., RLA 87-1874 (JAF), issued on October 31, 1991 pp. 23—27.

fn4 By way of example, defendants suggest that in order for an assignment of the collateral to result, a "Purchase and Assumption or similar assignment contract" should have been executed in addition to the endorsement of the promissory note. I Defendants also underscore the fact that other document , i.e. the passbook, deposit contract, signature card and bar ledger, are not and have never been in the plaintiff's possession. Whether execution of a contract and/or assess ion of the various banking instruments would substantiate the conclusion that an assignment of the passbook actually occurred need not be decided by the court as such evidence has not been produced for consideration.

fn5See, also, United States v. Gonzalez Medina, 797 F.2d 1109 (1st Cir. 1986)(title 31, section 3226 is not applicable to negotiable instruments as defined by 19 L.P.R.A. Sec 2).

fn6 It is not necessary to engage in the exercise of determining whether plaintiff's legal conclusions are correct as the t transaction involved in this suit was not completed pursuant to the provisions contained in the either the Civil Code or Mortgage Law.

fn7Given the findings herein, it is not necessary to discuss defendants' ' other arguments, that is, the allegations that the contract creating the collateral does not tie the collateral to the promissory note but to the Bank for past and future debts incurred by Mr Rua and that the pursuit of passbook account constitutes a chose in action which is not transferrable under 31 L.P.R.A. Sec. 3943.

THE BOWERY SAVINGS BANK, Plaintiff, v. COLONIAL MORTGAGE BANKERS CORPORATION, et al., Defendants.

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF PUERTO RICO

Civil No. 87-1874
Undated

On November 5, 1991, this court issued an Opinion and Order ruling on various summary judgment motions. Document No. 233). Before the court are motions by defendants Caguas Central Federal and Savings Bank ("Caguas") (Docket Document No. 236) and Hans Lopez Stubbe, trustee of Colonial Mortgage Banker's Corporation ("Trustee") (Docket Document No. 235) to amend the judgment pursuant to Fed R. Civ. P. 59(e). For the reasons stated below, we deny defendant motions for reconsiderations.

While the Trustee terms his motion as one to alter or amend the judgment pursuant to Fed. R. Civ. P. 59 (e), we note at the outset that no final judgment has been entered in this action. Therefore, pursuant to Fed. R. Civ. P. 54 (b), "the order or other form of decision is subject to revision at any time before the entry of judgment adjudicating all the claims and the rights and liabilities of all the parties." Accordingly, it is within this court's discretionary power to alter a grant of summary judgment any time prior to the entry of final judgment. Farr Man & Co.. Inc. v. M/V Rosita, 903 F.2d 871, 875 (1st Cir. 1990); Jusino V. Zayas, 875 F.2d

986, 989 n.3 (1st Cir. 1989). We therefore interpret both defendants' motions as motions for reconsideration of our earlier summary judgment rulings and not Rule 59(e) motions to amend judgment.

Caguas seeks reconsideration of our ruling that it violated Article 1802 of the Civil Code of Puerto Rico, 31 L.P.R.A. S 5141, in negligently assisting Rua and Colonial in the misappropriation of funds held in trust for plaintiff Bowery Savings Bank ("Bowery").

Caguas argues that this court erroneously found that the 500,000 withdrawn from the Bowers trust account at Banco Financier ("Financier") (Account #903-300346) were the same Moines which ultimately ended up in a Golden Passbook Savings account (Account #12-2-1330) at Caguas.fn1 Caguas has come forward with documentary evidence -- an accountant's affidavit and copies of three canceled checks -- to demonstrate that, while $500,000 were withdrawn from the Bowery trust account (#903-300346) and. deposited into another Colonial account at Caguas (#12-4-00705-1) , three checks were drawn on that latter account and deposited in the Bowery trust account (#903-300346). These latter checks were paid on the Caguas account on December 1, 1986. Caguas argued that since the same amount of funds were returned to the Bowery Trust account there was no misappropriation of Bowery funds and liability cannot attach.

Defendant misapprehends the basis of this court's ruling. We found Caguas liable based on their participation with Rua in the November 1986 transactions and their, subsequent acts misrepresenting Rua assets as those of Colonial. The material

facts relied upon the court were that: (1) normal bank procedures were not followed in evaluating and approving Rua loan and no Caguas bank official admitted authorizing the loan; (2) Bowery trust account funds (#903-300346) were used to conduct these transactions and, in fact, set in motion Rua misappropriation of Colonial funds; (3) The Golden Passbook account, while labeled a Colonial account, was in fact a personal account of Rua' s; (4) on two different occasions, Caguas
misrepresented this personal account as being a Bowery trust account to Bowery auditors. The bank's statements confirmed an oral misrepresentation made by Colonial officials that the Golden Passbook funds were held in trust for Bowery. Caguas was held liable for its assistance of Rua/Colonial I their misuse of Bowery Funds. The fact that the monies may have, in fact, been replaced in the Bowery trust account is not dispositive of the issue. The bank, therefore, was found to be joint tortfeasor with Rua / Colonial.

Again in their motion for reconsideration, Caguas has come forward with no evidence that would create a Fed. R. Civ. P. 56 genuine issue of material fact for trial. Caguas has not set fort credible evidence identifying the Caguas official who granted Rua the November 1986 loan or explaining why normal loan application, procedures were not followed. Caguas has failed to explain why the account was mislabeled or facts as to why the bank misrepresented the Golden Passbook account to Bowery auditors for over a year. These are acts done -. by Caguas which had the effect of assisting Rua/ Colonial in its breach of the mortgage servicing agreements.

Since the facts relied upon by the court remain uncontested, our original decision must stand.

Defendant Caguas' motion for reconsideration is denied.

Trustee López Stubbe

In the Trustee's motion, he argues that he has stated claims for which relief can be granted both against Bowery and against his codefendants. He further argues that this court, and not the bankruptcy court, should hear the remaining claims. He has also requested an extension of time pursuant to Rule 311.6 of the Local Rules of the United States District Court for the District of Puerto Rico to file a supporting brief. After reviewing the bases for our original decision, we rule that they should stand and that there is no need for the Trustee to file a memorandum of law. We therefore deny the trustee's motion, as well as his request for an extension of time to file a memorandum of law.

As to the counterclaim against Bowery, the trustee mentions Bowery's attachment of Colonial's origination account at Caguas. However, the attachment was nothing more than part of the commencement of a civil action which is allowed by law for the purpose of securing satisfaction of the judgment ultimately entered. Fed. R. Civ. P. 64; 32 L.P.R.A. App. III R. 56.

The gravamen of the Trustee's counterclaim remains that Bowery, after it had discovered that Rua had misused Bowery trust funds, had agreed to withhold legal action in

order to allow orderly payment by Colonial/Rua. Because of the findings that no oral agreement existed and that Bowery did nothing more than exercise its right to litigate, the Trustee has not presented sufficient facts to state a cause of action under Article 1802, 31 L.P.R.A. § 5142.

With respect to codefendants. Caguas and Financiero, the Trustee argues that there are triable issues as to whether the banks are liable in their own right or as aiders and abetters of Rua in his breach of fiduciary duty to Colonial. However, no specific facts are alleged in the cross-claim that could be construed to impute actual or constructive knowledge to the banks as to Rua activities. As we stated in section III (A) (2) of our Opinion and Order (at 21-23), where there are thousands of. transactions occurring involving numerous regular checking accounts, it would be impossible for the financial institution to monitor each transaction to assure that funds were not being misappropriated. Especially where, as here, the corporate officers themselves were the ones involved in the misuse of funds, specific facts need to be alleged to demonstrate that the bank knew of and assisted in the misappropriation by the fiduciary. Since such facts were not alleged, our earlier decision must stand.

Finally, as to our decision to refer the Trustee's remaining claims against Rua, his wife and the conjugal partnership to the bankruptcy court, we continue to believe that this specialized forum, which has had before it numerous proceedings arising out of

fn1For a more detailed description of the series of transactions between Colonial / Rua and Caguas, the reader

may turn to our Opinion and Order, Docket Document No. 233 at 6-8.

IN RE: COLONIAL MORTGAGE BANKERS CORPORATION, Debtor. CREFISA INCORPORATED, Plaintiff, Appellee, v. WASHINGTON MUTUAL BANK, F.A., Defendant, Appellant. HANS LOPEZ-STUBBE, TRUSTEE, Appellant.

No. 98-2273

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

September 2, 1999

The panel of judges that rendered the decision in this case having voted to deny the petition for rehearing and the suggestion for rehearing en banc having been carefully considered by the jduges of the Court in regular, active service and a majority of said judges not having voted to order that the appeal be heard or reheard by the ocurt En Banc,

It is ordered that the petition for rehearing and the suggestion for reheearing en banc, be denied.